S. HRG. 108–33

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2004

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

January 29, 2003—THE STATE OF THE ECONOMY

January 30, 2003—THE BUDGET AND ECONOMIC OUTLOOK

February 4, 2003—THE PRESIDENT'S FISCAL YEAR 2004 BUDGET

February 5, 2003—THE PRESIDENT'S FISCAL YEAR 2004 BUDGET PROPOSALS

February 11, 2003—THE PRESIDENT'S INTERNATIONAL AFFAIRS BUDGET

February 13, 2003—DEPARTMENT OF TRANSPORTATION'S FISCAL YEAR 2004 BUDGET PROPOSALS

February 26, 2003—THE PRESIDENT'S FISCAL YEAR 2004 BUDGET PROPOSAL FOR MEDICARE AND MEDICAID

September 3, 2003—THE PRESIDENT'S FISCAL YEAR 2004 BUDGET

Printed for the use of the Committee on the Budget

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THE STATE OF THE ECONOMY

WEDNESDAY, JANUARY 29, 2003

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

The committee met, pursuant to notice, at 10:08 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Don Nickles (chairman of the committee) presiding.

Present: Senators Nickles, Allard, Burns, Enzi, Sessions, Bunning, Crapo, Ensign, Conrad, Sarbanes, Nelson, Stabenow, and Corzine.

Staff present: Hazen Marshall, staff director; Dan Brandt, economist and Bob Taylor, special counsel.

For the minority: Mary Ann Naylor, staff director; and Lee Price, chief economist.

OPENING STATEMENT OF CHAIRMAN DON NICKLES

Chairman NICKLES. I call the Committee to order. I want to thank everybody for coming and especially thank my colleague and ranking member, Kent Conrad, for his assistance.

We have a series of hearings set up. Today will be on economic growth. We have three very distinguished panelists that will provide their expertise and insights on how we might be able to better grow the economy, and I appreciate their participation as well.

I would especially like to thank my friend and colleague, Senator Conrad, who has served on this committee I believe 16 years. He has served as chairman and ranking member, and he has also served in almost every position in this committee. I appreciate his service. The last Congress was a very difficult Congress. It is always difficult. This committee is a tough committee. I appreciate that, I recognize it, and I recognize and appreciate the willingness of our colleagues to serve on it. We have several new members on the Committee. I welcome them. I see Senator Conrad Burns has just joined the Committee as well as Senator Mike Enzi from Wyoming joining us, Senator Sessions from Alabama, Senator Bunning joins us as well. So we welcome you to the Committee. Senator Crapo has joined us, and Senator Ensign will be here as well. So we have some new members and some veterans. I believe Senator Hollings has been on this committee for 27 or 28 years. I have been on it for—I am not sure how long—a long time. It is kind of bad when you think, well, maybe 20 years or so.

I want this committee to be an enjoyable, educational, informative opportunity for all of us so we can better learn how to manage Government and maybe have a better success in the budgeting process.

We have a $2-trillion-plus budget. That is a big challenge. We don't have a $750 billion budget. Our budget is not just the discretionary amount. Our budget is the entire Federal budget. So we need to keep a lot of things in perspective.

We have some big challenges. We happen to be presiding now at a historic time. We have had a recession, and we have had revenue declines. We went from surpluses to deficits. That is caused primarily because revenues have fallen. Revenues have fallen by 9 percent in the last 2 years, the first time in history we actually had a revenue drop 2 years in a row. I believe it dropped from 2000 to 2001 1.7 percent and the next year almost 7 percent, combined, about a 9-percent drop in revenues. That is historic. At the same time, expenditures went up, and expenditures went up rather dramatically. Last year, they grew by 7.9 percent, and that is 11 percent if you exclude falling interest rate costs. So you had revenues declining and you had expenditures growing rather dramatically. So we went from a surplus of, I believe, $129 billion to a deficit of $159 billion just between 2001 and 2002.

Well, we need to reverse that, and hopefully one of the ways we can reverse that is by having a growing economy. The purpose of our hearing today is to figure out how can we grow the economy.

I compliment President Bush. He challenges us last night in the State of the Union Address. He made several recommendations to Congress on how we might better grow the economy. I compliment him for those proposals. We will have administration witnesses before this committee to explain those proposals and to hear ideas.

That is not the purpose of this hearing. The purpose of this hearing is to pull in individuals who are recognized as experts in their field to hear their insights on how we might better grow the economy and to have maybe a little dialog. So we will have administration witnesses. I believe we have scheduled tomorrow CBO, and they just issues the report, the budget and economic analysis. I haven't had a chance to look at it. It just came out. I think they are supposed to have a hearing in the House Budget Committee today. I believe that was canceled, so we will hear from them tomorrow. So we get a little more technical from CBO on what their analysis of it is, and then the following week we will hear from Mitch Daniels and administration officials to explain their budget and give us some insights as well.

So I look forward to working with all members of our committee. I look forward to our witnesses. Before I introduce our witnesses, I will call on the ranking member and my friend Kent Conrad for any opening remarks he might have.

OPENING STATEMENT OF SENATOR CONRAD

Senator CONRAD. Thank you, Mr. Chairman.

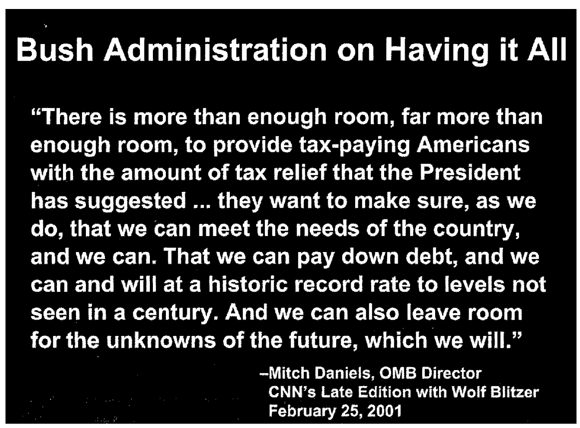
Thank you, first of all, for holding this hearing because I think it is a critically important subject. Thanks, too, for the new energy and attitude you have brought to the Committee. It is welcome and we look forward very much to working with you.

I want to report to our colleagues that the incoming chairman and his staff have been eminently fair in the operations of the

Committee, and we all appreciate that very much. They are professional and it has been a delight to deal with them.

I want to also welcome the new members. We have many new members, and we are delighted that they have joined the Committee. We look forward to working with you in the days ahead as we discuss really critical choices for the country. What do we do with the budget of the United States? What do we do to promote growth? What do we do to improve the national defense and improve education? What do we do to secure the long-term fiscal strength of our Nation?

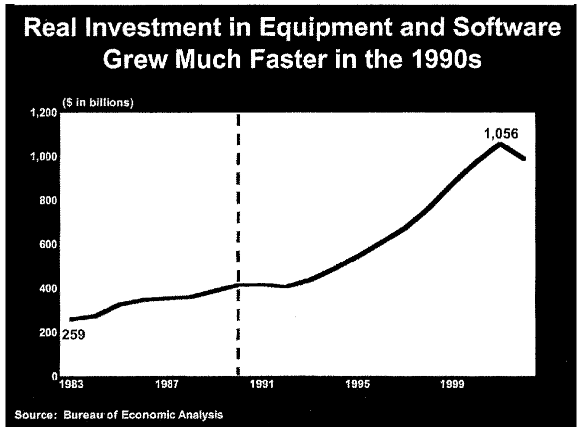
It won't surprise you, Mr. Chairman, if I just turn briefly to a few charts to make the point on what I think I have learned from my past service here in terms of what is effective.

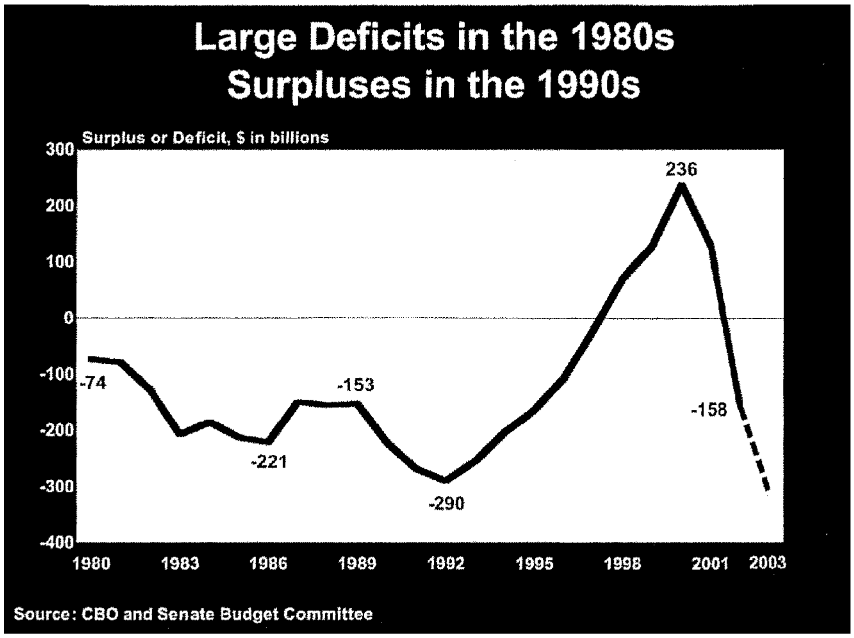


I want to go back to the 1980's when we had a policy of a significant tax cut at the same time we were having a significant military buildup, and what we saw was the deficits increased dramatically. Then in the 1990's, we changed course, and we moved back toward balanced budgets. I want to just talk about what I learned from those changes.

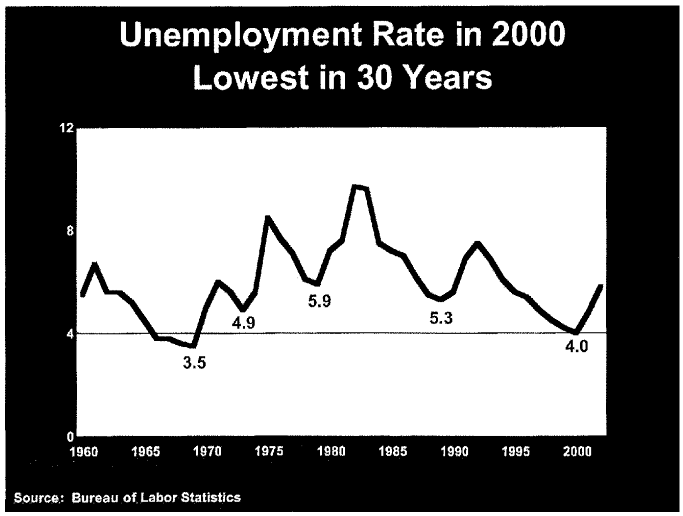
During the period of the 1980's, when deficits were growing dramatically, I believe Federal Government borrowing was squeezing out private investment; that as the Government competed for funds, that reduced funds available for investment. Investment is critical to economic growth.

Then we saw a change and, instead of adding to deficits and adding to debt, we started growing out of deficits, we got very good results in the real world. Real investment in equipment and software grew much faster in the 1990's than in the 1980's.

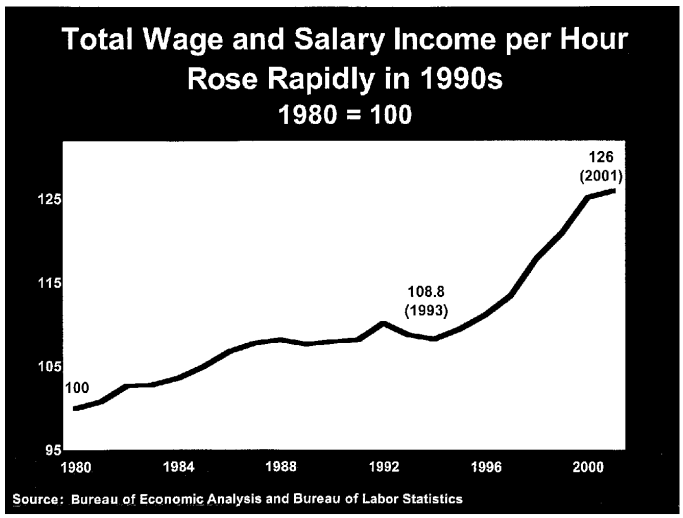

Real Investment in Equipment and Software
Grew Much Faster in the 1990s
($ in billions)
1,200
1,000
800
600
400
200
0
259
1,056
1983
1987
1991
1995
1999
Source: Bureau of Economic Analysis


Large Deficits in the 1980s
Surpluses in the 1990s
Surplus or Deficit, $ in billions
300
200
100
0
-100
-200
-300
-400
236
-74
-153
-158
-221
-290
1980
1983
1986
1989
1992
1995
1998
2001
2003
Source: CBO and Senate Budget Committee

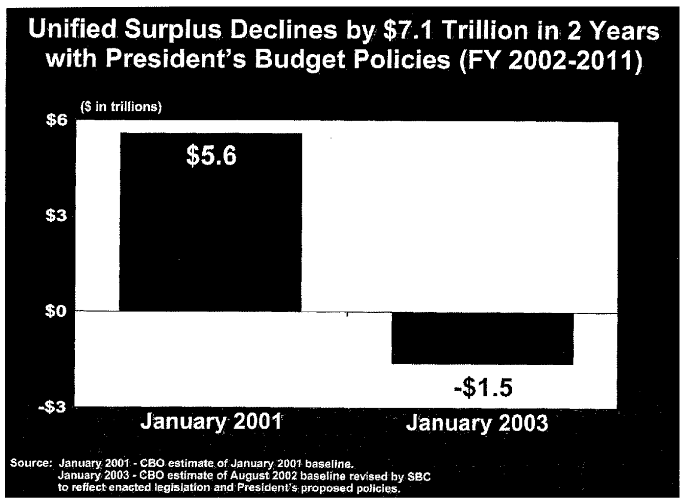
Let's go to the next chart. The unemployment rate fell to the lowest level in 30 years at this time that the Federal Government was moving toward fiscal balance.



Let's go to the next one. Total wage and salary income rose rapidly in the 1990's, again, much faster than in the 1980's.

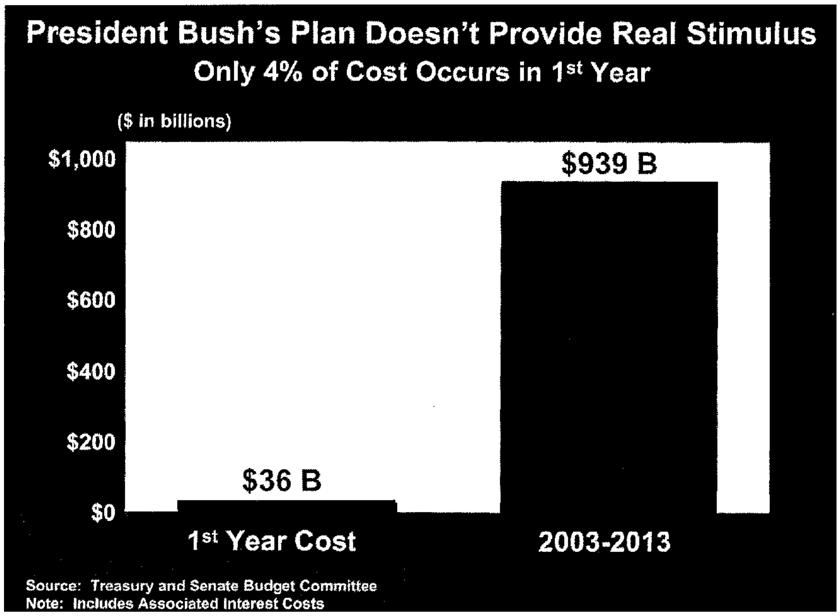


Now we face a circumstance in which 2 years ago the projections were by the Office of Management and Budget and the Congressional Budget Office that we would have $5.6 trillion of surpluses over the next decade. Now we see that that circumstance has changed dramatically. If we adopt the President's policies, the additional tax cuts that he is advocating, the spending that he is advocating, we will be $1.5 trillion in the red.

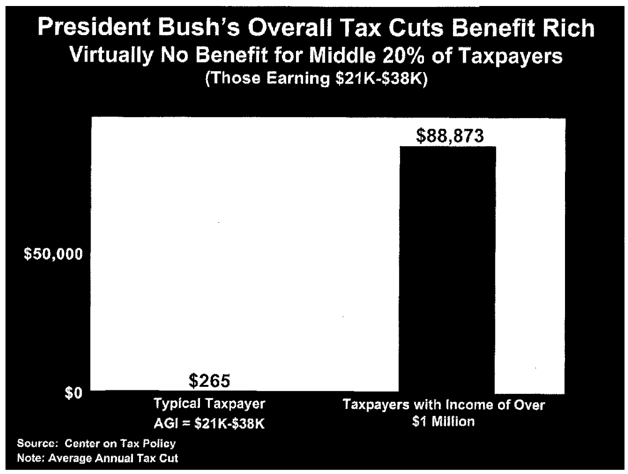


When I look at his specific plan for economic growth, the stimulus plan or the growth plan, it strikes me that it will be ineffective in the following ways:

First of all, only a small part of it is effective in this fiscal year, some $36 billion this fiscal year, with a 10-year cost of over $900 billion when the associated interest cost is included.

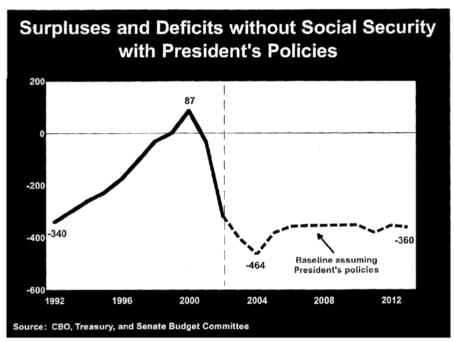

President Bush's Plan Doesn't Provide Real Stimulus
Only 4% of Cost Occurs in 1st Year
($ in billions)
$1,000
$800
$600
$400
$200
$0
$939 B
$36 B
1st Year Cost
2003-2013
Source: Treasury and Senate Budget Committee
Note: Includes Associated Interest Costs

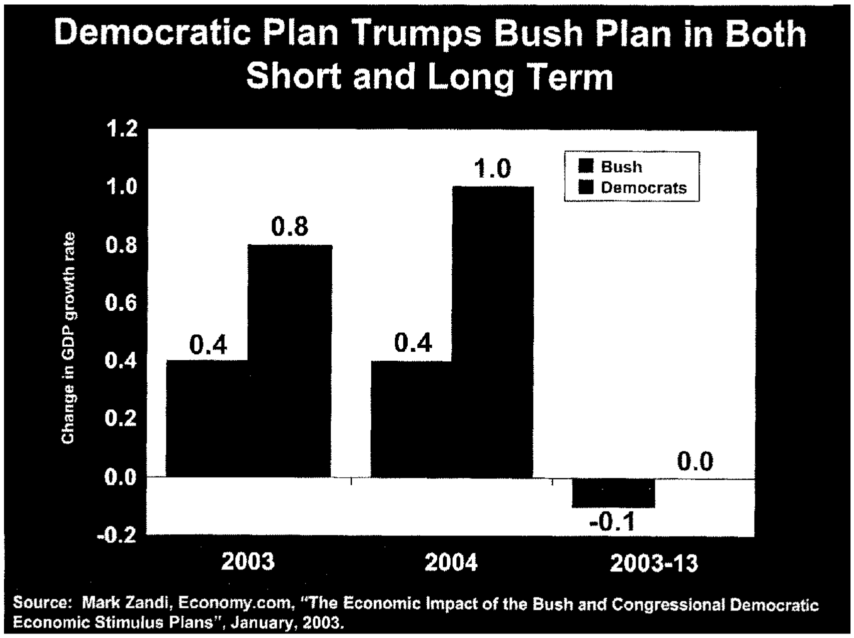
It also strikes me that it will be ineffective because it is so heavily weighted to the highest-income people in our country. Those earning over $1 million a year will get an $88,000 tax reduction, but those in the middle of the income stream in this country, those in the middle 20 percent who earn between $21,000 and $38,000 a year will get, on average, only $265. Yet those are the people that are very most likely to spend the money and thereby stimulate the economy.



It also strikes me that over the long term it will be ineffective because of the deficits and debt that it will add. This is to me the key point.

We are looking ahead with the new CBO numbers. If Social Security is not used, is not invaded for other purposes, we see deficits throughout the whole rest of the decade of very, very large proportion, approaching $4 trillion. It is for that reason that on our side we have proposed a different stimulus package, one that has much more stimulus now, but much less cost over the 10 years. We have just received an evaluation from Mark Zandi, the economist that has now been widely quoted in the Wall Street Journal and on the various news programs. His conclusion is that for 2003 the Democratic plan would give us about eight-tenths of 1 percent growth in GDP; the Republican plan, about half as much. The same is true for 2004: the Democratic plan, about 1 percent of GDP growth, in addition to what will otherwise occur; the Republican plan, about four-tenths.




Democratic Plan Trumps Bush Plan in Both Short and Long Term
Change in GDP growth rate
1.2
1.0
0.8
0.6
0.4
0.2
0.0
-0.2
Bush
Democrats
0.4
0.8
0.4
1.0
-0.1
0.0
2003
2004
2003-13
Source: Mark Zandi, Economy.com, "The Economic Impact of the Bush and Congressional Democratic Economic Stimulus Plans", January, 2003.

The bigger message is the long term. In the long term, he finds, as have other econometric modelers, that the President's plan will actually hurt growth—by a very small amount but, nonetheless, negative. The reason is that the growth of deficits and debt will provide a drag to the economy that overwhelms the increased efficiency one gets from the tax changes that are made.

That tells me, Mr. Chairman, that we do have a real challenge. How do we forge a plan that gives lift to the economy now, but doesn't endanger long-term growth by adding to deficits?

Chairman NICKLES. Senator Conrad, thank you. I am going to try and make sure that we don't have this turn into a debate between you and me. I could respond, but I won't at this time.

Do any other colleagues wish to make a comment before I introduce our guests? If not, we are delighted to have three outstanding panelists, and I seek and welcome your testimony today. Your statements will be inserted into the record.

First, I am going to ask you—I am not going to set a time limit, but if you would keep your remarks to 7 or 8 or 9 minutes, then we will open it up for questions. I am not ringing a bell.

First we have David Malpass. He is the Bear Stearns chief global economist. I have had the pleasure of knowing him for some time. I respect and admire his work. He has had a series of economic appointments during the Reagan and Bush administrations, including 6 years with Secretary James Baker at Treasury, and also the State Department. Mr. Malpass has extensive experience on economic, budget, and international issues, including the 1986 tax cut and the Gramm-Rudman budget law. So, Mr. Malpass, welcome.

STATEMENT OF DAVID R. MALPASS, CHIEF GLOBAL ECONOMIST, BEAR STEARNS & COMPANY, INC.

Mr. MALPASS. Thank you, Senator. Mr. Chairman, Senator Conrad, members of the Committee, thank you for the invitation to testify.

What I propose to do, Senators, is go through in detail the first page of my prepared testimony, and then explain the graphs as a way to summarize the prepared testimony.

The economy faces an unusual number of near-term problem: Iraq, the war on terrorism, artificially expensive oil, sudden weakness in the U.S. dollar, a large and growing current account deficit, rapid growth in Federal Government spending, and a 3-year decline in equity values.

Arrayed against these problems are the small-business character of the U.S. economy, record low interest rates and inventory-to-sales ratios. Inventories are at low levels now. We have the likelihood, I think, of a pro-growth tax cut. We have a strong, flexible labor force, 131 million workers in the United States with fast productivity growth.

The balance, in my view, is favorable for the longer-term U.S. outlook. I will be more confident about the near term when Iraq disarms, a growth-oriented tax cut passes Congress, and oil prices find a lower level based on market forces rather than a cartel.

A growth-oriented tax cut is a critical part of the recovery. Our economic health depends on the efficiency of the capital and incentive structures rather than on cash in the consumer's pocket. I disagree with the view that consumption is the weak part of the economy or that a demand-oriented tax cut is a necessary step for economic recovery.

One key to faster economic growth is to shift from the present debt-biased capital structure to a more balanced one. That is why President Bush's proposal to eliminate the double taxation of dividends would, in my view, add to both the near- and long-term growth outlook. Remember that double taxation causes a heavy bias toward debt in the corporate structure.

There is an additional urgency for the U.S. to make progress on a growth agenda. In most other parts of the world, economies are substantially weaker than ours. Unemployment rates are higher, government spending and unfunded pension liabilities are even greater than our own, health care systems are less effective, and currencies even more volatile than the dollar.

As a result, clear U.S. leadership will play a critical role in helping improve growth policies elsewhere, including promoting tax reform, currency stability, sensible environmental policies, and restraint in the size of Government.

What I would like to do now is show you some of the graphs in my prepared testimony. On page 2, there is a graph showing some budget issues, and the first graph is one showing how well economists do in forecasting the growth rate. The graph shows you that economists do badly at this task. You can see in the 1990's, for example, how CBO and OMB both expected certain growth rates, roughly 2-3 percent, and the actual economy grew much more strongly. Then in 2000-2001, we saw the actual growth rate well below the OMB and CBO expectations. CBO just put out a new report this morning, and one thing they do is show the sensitivity of the budget deficit to growth. They find that the change in the Fiscal Year 2002 fiscal deficit was a $471 billion deterioration; of that, 16 percent was caused by tax cuts, another 16 percent by new spending, and fully 68 percent by the change in the economic outlook.

So what they are saying basically is that growth is critical to the fiscal deficit much more so than the assumptions on the deficit effect of a tax cut.

Looking out over 10 years, what CBO found was that the numbers are more clear against government spending. Of the $5.6 trillion deterioration in the fiscal outlook, the tax cuts caused less than a quarter of that, spending caused a full third, 32 percent, and the slower economic growth caused nearly half of the deterioration in the longer-term fiscal outlook.

The graph that I show on the bottom of page 2 illustrates this. We fall into a big fiscal deficit 2.5 percent growth. If you have a 3.5-percent growth rate, you run into big surpluses in the outyears.

Small changes in the growth outlook, meaning half-percent changes in the longer-term growth outlook have a great deal of control over the fiscal deficit.

I would like to show you now page 4. What happened in 2002 was the aftermath of a recession. We can all regret it and regret the loss of jobs. By the numbers, it was a shallower recession than what we have seen. The peak to trough was the shallowest that we have on record.

On page 5, I am showing business equipment spending. We often hear the idea that there was simply no investment taking place in 2002. In reality, the rate of recovery was pretty much in line with averages. By the third quarter of 2002, we were back at the level of business equipment spending that was the average of the boom years, of the 1997-to-2000 period shown on the graph.

At the bottom of 5 and the top of 6, I show a chart about the peak to trough job losses. Again, as I emphasize, it is unfortunate to lose any jobs, but when you have a recession, you do lose jobs. What we saw in the recent recession is that the job losses in this last recession peak to trough were 1.7 million. That was 1.3 percent of the labor force. The U.S. economy and the number of workers is just much bigger than what we used to have. 1.7 million job losses is unfortunate, but relative to GDP was the smallest loss in jobs from peak to trough of any of the recessions going back into the 1960's.

At the bottom of 6, even though the unemployment rate has climbed now to 6 percent, it is below what used to be the normal unemployment rate or even the trough unemployment rate. In the 1970's, the unemployment rate never really got down to the current level.

The gist of this is that while we have to focus on getting more jobs into the economy, it was a shallower-than-normal recession, and a shallower-than-normal recovery. Fewer jobs were lost than in the normal peak to trough recession.

One of the reasons for that is that personal income growth was strong in 2001 and 2002, well above average. The top of 7 shows you the current path of personal income growth versus what the average cycle. One of the reasons for the strength of personel income growth was the strength of the economy leading into the recession in 2001, but also the tax cuts that occurred in 2001.

We had unusually well-timed fiscal and monetary stimulus that allowed a shallower-than-normal recession and better-than-normal personal income growth.

On page 7 and 8, I describe the consumer behavior. We often hear the idea that the consumers were profligate, spendthrift. Certainly we could all save more, and that would be good. As we look at the data, there is a huge discrepancy in the government data. They exclude capital gains income from income. 52 percent of Americans hold equities, either directly or indirectly now. As people took capital gains, the Government didn't see that income, didn't record it. Capital gains tax was considered an expenditure. The higher the stock market went in the 1990's, the worse it looked for the personal savings rate. It gave the Government justification for taxing money away from people by saying, look, the people aren't saving. In reality the low savings rate was purely a mistake in the Government personal savings data.

At the bottom of 8, we have tried to adjust the savings rate simply to include one of the discrepancies, the realized capital gain. People actually were saving at a relatively steady rate in the 1990's, and I think that has continued up through 2002. So as you think about how to build a tax cut, be leery of the idea that you have to have a tax cut to replace lost consumption. There really wasn't any lost consumption, and there really wasn't as much lost savings. This is particularly true at the lower-income levels because their personal wealth and net worth is much more tied up in the home than in equities. As you go up in the income brackets, people lost more from the stock market, but at the lower income levels they still may have a home and a job, and that turns out to be the critical part of consumption.

On page 9 of my prepared text, I go through reasons for thinking that the capital structure is really what you ought to focus on in thinking about a tax cut. We have a heavily skewed system in the United States where debt is strongly encouraged by the Tax Code. President Bush has proposed a way to somewhat level the playing field. I think it would be very stimulative in both the short and the long run—

In the middle of 10, I address municipal bonds. I think there is a little bit of confusion going on there. One of the criticisms of the tax proposal is that it might disadvantage municipal bonds. I disagree on two grounds:

First, in economic theory and practice, municipal bond yields are related to the after-tax return on U.S. treasury securities. President Bush's proposal to eliminate double taxation of dividends won't affect that calculation.

Second, municipal bonds are substantially different from dividend-paying equities in terms of creditworthiness and volatility. The two instruments aren't very good substitutes for one another. I don't agree with the idea that eliminating double taxation of corporate income would somehow disadvantage State and local governments. In fact, I think they would benefit immensely from the new jobs that are created in the economy by the proposal.

On page 10 and 11, my testimony goes through foreign experience with double taxation of dividends. What we find is that the U.S. is one of only three major economies that double taxes corporate income. As a result, the U.S. has the second highest combined top tax rate on dividends. The only country that has a higher tax rate on dividends is Japan. That is an aberration in our system.

Chairman NICKLES. Mr. Malpass, do you have a chart that shows effective countries' tax rates on dividends?

Mr. MALPASS. The text on page 11 goes through a breakout of countries. On page 10, it points out that only three countries—the U.S., Switzerland, and Ireland—have double taxation.

Chairman NICKLES. I would just be interested, if there is a chart, I would be interested in seeing what other countries are doing, if you have it. I am not asking you to do——

Mr. MALPASS. I don't have it here, but I will be happy to provide it.

Chairman NICKLES. I appreciate that. You kind of need to summarize so I can get to the other panelists.

Mr. MALPASS. I will finish it here.

Deficits and interest rates are connected on page 11. There really isn't a correlation between the fiscal deficit and interest rates. In the 1980's 10-year bond yields fell throughout the decade even as the fiscal deficit was rising. In 1999 and 2000, as we moved into sizable fiscal surpluses, bond yields were rising sharply.

In summary, the Administration's tax proposal will, in my view, provide substantial near-term and long-term stimulus. It will reduce the distortion in the U.S. capital structure and boost the U.S. growth rate. I think there are obviously many other things that should be done at this point to stimulate growth because, that is the dominant factor in the fiscal deficit.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Malpass follows:]

Statement of
David R. Malpass before the
Senate Budget Committee
January 29, 2003

Chairman Nickles, Senator Conrad, members of the Committee, thank you for the invitation to testify on policy issues and the economic outlook.

The economy faces an unusual number of near-term problems – Iraq-related uncertainty, the war on terrorism, artificially expensive oil, sudden weakness in the U.S. dollar, a large and growing current account deficit, rapid growth in federal government spending, and a three-year decline in equity values.

Arrayed against these problems are the small-business character of the U.S. economy, record low interest rates and inventory/sales ratio, the likelihood of a pro-growth tax cut, a strong, flexible labor force of 131 million workers, and fast productivity growth.

The balance, in my view, is favorable for the longer-term U.S. outlook, but I will be more confident about the near-term when Iraq disarms, a growth-oriented tax cut passes Congress, and oil prices find a lower level based on market forces rather than a cartel.

A growth-oriented tax cut is a critical part of the recovery. In my testimony, I describe how our economic health depends on the efficiency of the capital and incentive structures rather than on cash in the consumer's pocket. I disagree with the view that consumption is the weak part of the economy or that a demand-oriented tax cut is a necessary step for economic recovery.

One key to faster economic growth is to shift from the present debt-biased capital structure to a more balanced one. That's why the President's proposal to eliminate the double taxation of dividends (which heavily biases the corporate sector toward debt) would, in my view, add to both the near- and longer-term growth outlook.

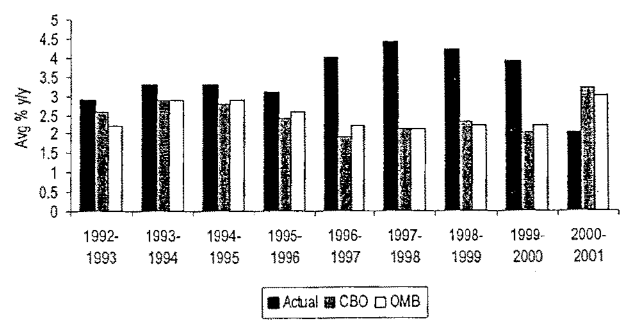
There is an additional urgency for the U.S. to make progress on a growth agenda. In most other parts of the world, economies are substantially weaker than ours, with unemployment higher, government spending and unfunded pension liabilities even greater than ours, health care systems less effective, and currencies even more volatile.

As a result, clear U.S. leadership will play a critical role in helping improve growth policies elsewhere, including promoting tax reform, currency stability, sensible environmental policies, and restraint in the size of government.

On budget issues, I would like to make several observations:

- Forecasting budget deficits is an art, not a science. This is true of most of economics. For example, in the 1990s growth was consistently above the forecast. Conversely, the recession produced growth well below forecast.

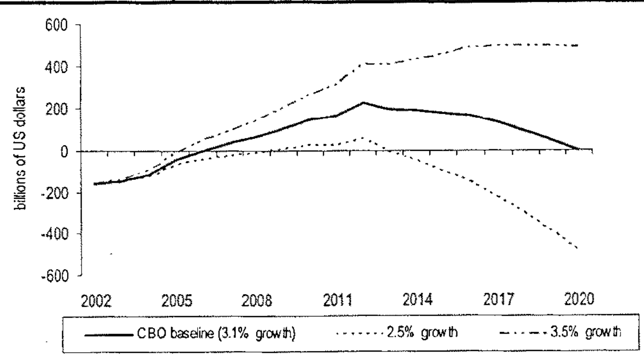
Two Year Real GDP Growth: Actual Vs. Forecast



Source: Bloomberg; Bear, Stearns & Co. Inc.

- Budget deficits are very sensitive to growth rate assumptions.

Long-term Government Budget Paths Under Different Growth Assumptions



Source: Congressional Budget Office and Bear, Stearns & Co. Inc.

- The connection between budget deficits and interest rates is complex. Interest rates and bond yields respond to expectations for currency levels, inflation and economic growth. Budget deficits, especially the quality of government spending and taxation, can affect these. For example, to the extent that a tax rate cut is viewed as growth-oriented, it may strengthen the currency, lower the inflation expectations, and lead to lower interest rates. We saw this phenomenon in the 1980s. A later portion of my testimony goes into this issue in detail.

Economic Outlook

The economy showed resilience in 2002 in the face of Iraq uncertainty, expensive oil, the accounting and litigation concerns that peaked in August, and economic weakness abroad. Growth paused in the fourth quarter, though most of the weakness looks to have been concentrated in October. We'll get a fuller picture with the January 30 release of fourth quarter GDP.

The current peak in near-term uncertainties will probably keep growth soft in the first quarter of 2003. As the year progresses, the economy should get a strong boost from an Iraqi disarmament, the associated drop in oil prices, and passage of a pro-growth tax cut. I expect the economy to be running at a 4% growth rate by the fourth quarter of 2003.

I am confident about the medium-term economic outlook. The U.S. economy showed resilience in 2001 and 2002, not fragility. I expect similar strengths to continue in spite of terrorism concerns and economic weakness abroad.

I expect the U.S. to move past the "piece-by-piece" recovery of 2002, which was the logical aftermath of the 1997-2001 deflation. Assuming progress on Iraq's disarmament, the next economic phase should be a more normal expansion focused on earnings and business investment.

2002: Aftermath of Deflation

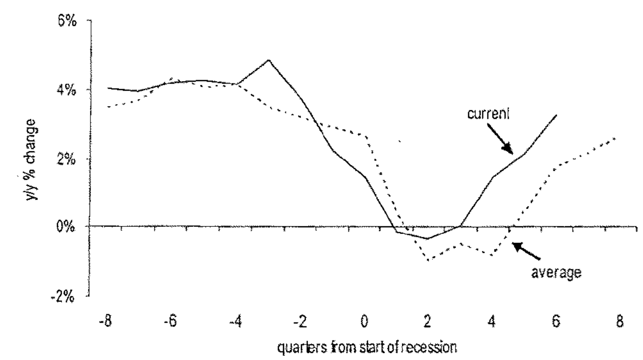
The U.S. economy underwent a moderate recovery in 2002. It was characterized by higher levels of employment and lower inflation than in recent recessions, but relatively weak growth in investment and inventories. Prices paid to corporations fell while average wages rose, squeezing corporate profits. New home sales hit a record of 981,000 new homes sold in 2002, a new record.

Other recent recessions were uniformly a response to *inflation*. In contrast, the 2001 recession was, in my view, a response to the deflationary pressures of the ever-strengthening dollar policy of 1997-2001.

The magnet of the strong dollar policy supported by high real interest rates contributed to over-investment in the U.S. and a massive transfer of resources from the private sector to the government through the capital gains tax. The government was able to pay down the national debt, but the private sector built record debt levels.

The 2001 recession was the mildest recession on record in terms of lost real GDP from the peak. Even though the recovery was moderate, the current level of GDP is farther above the trough than in previous recessions. But the recovery is turning out to be a long period of sub-par economic growth.

GDP Growth in Current and Past Recessions



Source: Bloomberg and Bear, Stearns & Co. Inc.

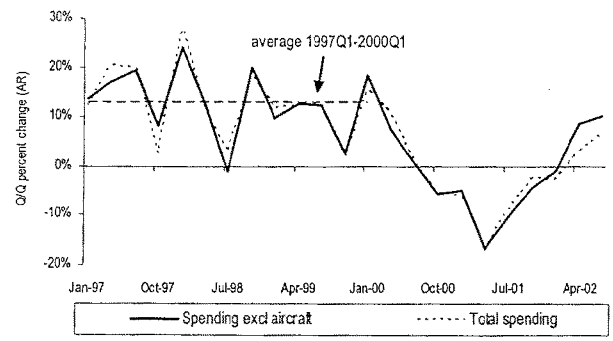
We estimate that, once fourth quarter GDP figures are published, the economy will have registered real GDP growth of 2.7% (comparing the fourth quarter of 2002 to the fourth quarter of 2001 at annualized rates).

Growth in Business Investment, Employment and Personal Income

Contrary to the common perception that businesses didn't invest in 2002, the data shows almost across-the-board growth in equipment spending except for aircraft. Aircraft production and commercial construction stalled in the aftermath of September 11. Apart from these two areas, business spending was up almost universally in the first three quarters of 2002, rising at a 5.9% annual rate in the first three quarters of 2002 and increased 11% in the third quarter (quarter-over-quarter seasonally adjusted annual rate.) When aircraft are excluded from total business spending on equipment, spending growth is approaching the average pace of the 1997-2000 boom.

Business spending including aircraft grew from a $954 billion annual rate in the first quarter of 2002 to a $977 billion annual rate in the third quarter. This dwarfs the rate of investment in any other part of the world. The eurozone's annual rate of investment in the second quarter of 2002 was only $452 billion.

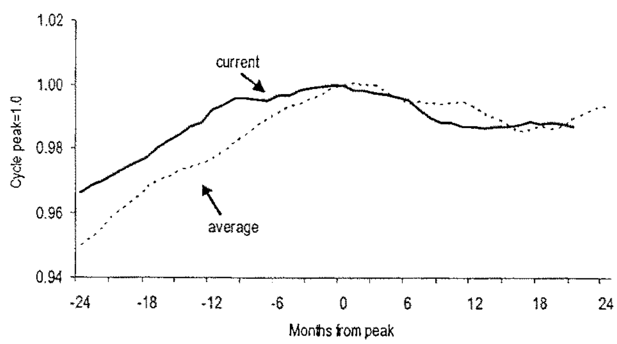
Business Spending on Equipment (1996 Dollars)



Source: Haver DLX; Bear, Stearns & Co. Inc

As the economy has become increasingly flexible and responsive to business conditions, so has the labor market. In past recessions, there was a lag between the peak of the business cycle and the peak of employment, but this lag has disappeared. There hasn't been much re-hiring in this cycle, in part because there wasn't as big a drop in employment during the recession. The result is that, relative to previous recessions, employment is at about the average spot for 21 months after the start of the recession.

Employment Level: Current Vs. Average Recession



Source: Bloomberg; Bear, Steams & Co. Inc.

The peak-to-trough loss in employment in the 2001 recession was 1.7 million jobs or 1.3% of employment. This is relatively small shrinkage in the labor force (see the table), in part due to the unusual timeliness of the fiscal and monetary stimulus applied in 2001.

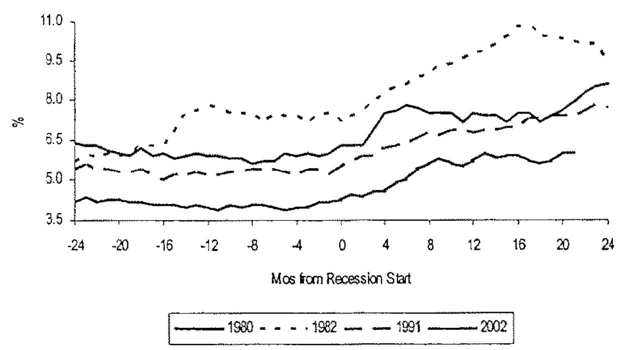
Changes in Employment; Peak to Trough (Millions of Employees)

Date	Peak	Trough	Chg, Mns	Chg, %
1970	71.4	70.3	-1.1	-1.5%
1974-75	78.6	76.3	-2.3	-2.9%
1980	91.0	89.7	-1.3	-1.4%
1981-82	91.4	88.7	-2.8	-3.0%
1990-1991	109.9	108.1	-1.8	-1.6%
2001-2002	132.4	130.7	-1.7	-1.3%

Sources: Bloomberg; Bear, Stearns & Co. Inc.

Today's 6% unemployment rate is well below the recent post-recession peaks in 1992 (7.9%), 1982 (10.8%), and 1980 (7.8%). Of course, I would like to see the unemployment rate substantially lower. Given the strong productivity growth taking place, I think the U.S. economy will be able to enjoy sub-5% unemployment in the future without it being inflationary.

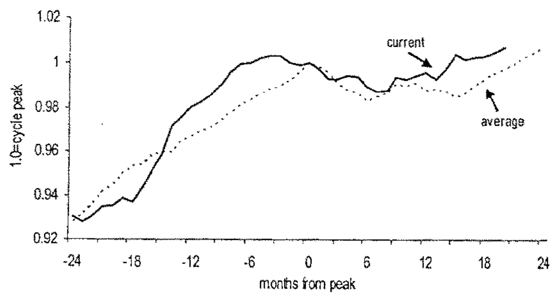
U.S. Unemployment Rates in Recession



Source: Bloomberg; Bear, Stearns & Co, Inc.

With employment levels much higher than in previous recessions, personal income growth during the 2001 recession was stronger than the average. Tax cuts and extended unemployment benefits also helped support personal income in the current cycle.

Personal Income: Current Cycle vs. Average



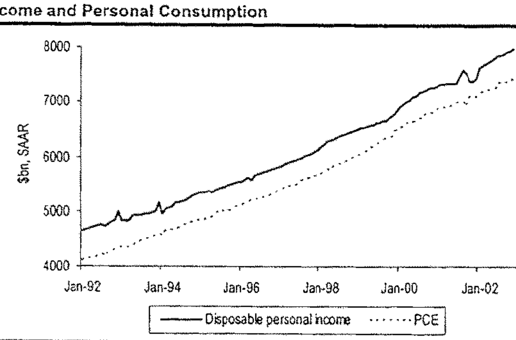
Source: Bloomberg, Bear, Stearns & Co. Inc.

Consumers haven't been as spendthrift as official figures show

Some argue that the sluggishness of the 2002 recovery is a shortage of cash in the hands of the consumer. This influences their economic outlook, the tax debate, and the debate over private savings accounts within social security. A common perception is that consumers wasted their money in the 1990s, justifying government efforts to give tax rebates and control retirement programs. Before getting into tax policy issues, it's important to evaluate consumer savings and balance sheets.

I think consumers tend to consume based on their life-time earnings expectations. There were two important changes in that outlook in the 1990s. First, the unemployment rate fell to much lower levels, establishing what I think will be a new lower non-inflationary rate of unemployment. Second, personal income grew through the 2001 recession. Combined, these two factors justified steady growth in consumption in 2002 and suggest that consumption will grow in 2003 and beyond.

Personal Income and Personal Consumption



Source: Haver, Bear, Stearns & Co. Inc.

A frequent argument is that the private savings rate went negative in the late 1990s, creating a shortage of consumption and arguing for Keynesian-style short-term stimulus in 2003. I disagree.

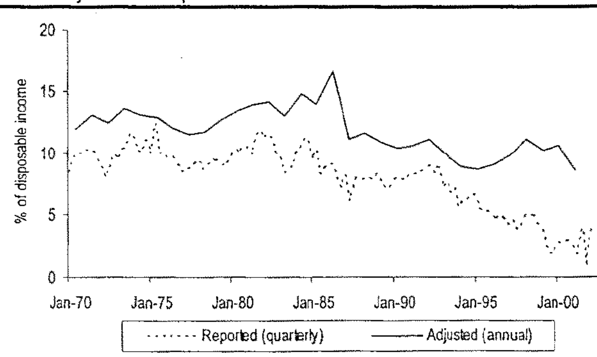
The official savings rate (released by the Commerce Department with the monthly report on personal consumption and income) is a misleading measure of savings and the consumer's financial health. The savings rate is calculated by subtracting consumption from a measure of disposable income. One of the major deficiencies in the personal savings data is that they ignore realized capital gains in calculating disposable income and therefore severely understate personal savings when equities rise.

Consider this example:

- A consumer realizes a $1,000 capital gain, pays $200 in taxes, and increases his savings account by $800. The government data on personal savings would, believe it or not, show a decline in savings. The capital gain is not included in the calculation of income, but the tax on the gain is deducted from disposable income. In this example, the government's measure of disposable income fell by $200, so personal saving is presented as having fallen by $200 (even though it actually rose by $800).

To get a better picture of savings in the 1990s, we adjusted the personal savings rate for just one of the missing items -- by including realized capital gains in disposable income. The graph shows a dramatic, positive effect on the savings rate in the 1990s, when capital gains realizations were strong. This is consistent with the recession experience of 2001 and 2002, in which consumer balance sheets were strong enough to support consumption growth despite cries that the consumer must be "tapped out."

Savings Rate Adjusted for Capital Gains Income



Source: Haver; Congressional Budget Office; Bear, Stearns & Co. Inc. estimates

The reported savings rate has been rising in recent months. We think this reflects the crash in capital gains realizations more than a change in consumer savings behavior. As adjusted, the savings rate was relatively stable in the 1990s and, we think, remained in normal ranges in 2002.

The Fed has just released its survey of consumer finances for 2001 (Federal Reserve Bulletin, January 2003). It helps explain the strength of consumption in 2001 and 2002. The Fed survey found that the consumer's balance sheet improved dramatically from 1998 to 2001.

The Fed samples family net worth on a three-year cycle that includes 1992, 1995, 1998, and 2001. The real net worth of the median family rose 10.4% from 1998 to 2001, reaching $86,100. This is slower than the 17.4% increase between 1995 and 1998 but above the 8.3% increase between 1992 and 1995.

- The survey also showed that the real income of the median family jumped 9.6% from 1998 to 2001, nearly four times the 2.5% increase in the preceding three-year period.

- The level of debt carried by families rose from 1998 to 2001. However, despite the 2001 bear market, the value of equity holdings and principal residences rose more. This lowered the debt-to-asset ratio and allowed family net worth to increase substantially.

- The Fed survey showed that debt-servicing burdens also fell. The percentage of disposable income devoted to debt servicing fell to 12.5% in 2001 from 14.4% in 1998. This measure of debt burden declined for almost every demographic group examined by the survey. It reflects in part the growth in personal income, the decline in interest rates in 2001, and the 2001 tax cut.

We continue to disagree with the view that the consumer is close to a double dip or is near a financial crisis. Instead, we think consumption growth depends heavily on current and future employment, real wage growth, and expectations about taxes. We expect consumption to grow moderately in 2003, especially in the event of a retroactive income tax cut.

Improving the Capital Structure

Much of my testimony has lauded various structural aspects of the U.S. economy. It stands out around the world in terms of productivity and flexibility, auguring well for long-term growth.

However, one area where the U.S. is sorely deficient is the tax code. We suffer from very high marginal income tax rates, a heavy payroll tax on both the employer and employee, and huge tax incentives encouraging all types of debt -- high-yield corporate debt, state and local debt, mortgage debt, etc.

As a result, one of the key variables in the economic outlook is whether the federal government can find a process to rebalance the playing field in terms of the capital structure.

The President's proposal to eliminate the double taxation of dividends and reduce the double taxation of corporate earnings would, if enacted, have a far-reaching, positive impact on the economy and equity markets, both near and longer term.

When you tax something less, you get more of it, in this case more capital and labor. That would mean more productivity, jobs and economic growth.

- The Bush proposal would lower the taxation of labor and small business entrepreneurism (by lowering marginal rates).

- It would also lower the taxation of capital (by eliminating double taxation and allowing an increase in basis for deemed dividends.)

- On the same principle, the proposal would encourage taxable income (in order to provide tax-free dividends) and more corporate earnings. It would discourage U.S. companies from moving their headquarters off-shore to avoid U.S. tax.

- At present, there's a wedge, an expensive toll gate, between corporate earnings and shareholders. Reducing the toll would increase the value of equities, including companies with current earnings and those with the prospect of becoming profitable.

- With 52% of all U.S. house-holds owning equities in some form, steps to encourage dividends and equity appreciation should provide a broad stimulus to the economy.

One of the criticisms of the tax proposal is that it might disadvantage municipal bonds. I disagree on two grounds. First, in economic theory and practice, municipal bond yields are related to the after-tax return on U.S. Treasury securities. The proposal to eliminate double taxation of dividends wouldn't affect that calculation. Second, municipal bonds are substantially different from dividend-paying equities in terms of creditworthiness and volatility. The two instruments aren't very good substitutes for one another.

We also disagree with the criticism that the stimulus from the tax cut depends on consumption or cash rebates. Consumption wasn't a weakness in the economy in the 2001 recession, so the key impact will come from improving the U.S. growth outlook.

Double Taxation Abroad

Policy makers in most other industrial countries have recognized that high rates of taxation on the earnings of capital distorts saving and investment and as a result, restrains economic growth. Of the thirty developed countries tracked by the OECD (Organization for Economic Coordination and Development), only three—the U.S., Switzerland, and Ireland—do not offer any relief from the double taxation of dividends.

Relief from double taxation takes on several forms:

- The most popular form is to tax dividends received by individuals at lower rates than other income. At least fourteen nations have chosen this type of relief.
- A close second in popularity is to provide individuals a tax credit based on the taxes paid by the firm.
- Three nations (Germany, Greece, and Luxembourg) offer partial or complete exclusion of dividends from individual taxation.
- And two nations have chosen to allow firms to deduct part of the dividends they pay to individuals, a parallel treatment to the one given to interest expense.

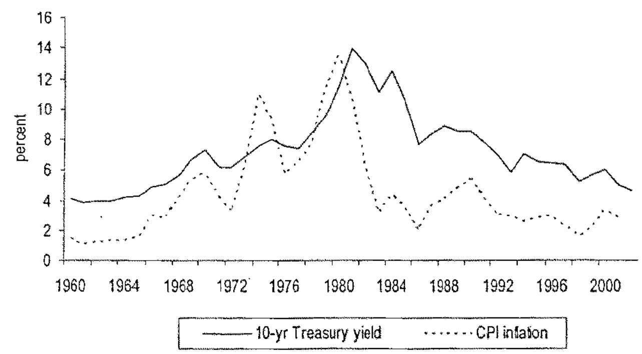
Of the countries studied by the OECD, the U.S. has the second highest combined top tax rate on dividends—exceeded only by Japan. Capital flows easily all around the world, so we should expect the higher U.S. tax rates on capital to gradually reduce investment in the U.S. from what it might otherwise be.

Deficits and Interest Rates

President Bush's tax cut proposal has rekindled the long-running debate over the relationship between the government's budget position and long-term interest rates. The relationship is complex. Interest rates and bond yields respond to expectations for currency levels, inflation and economic growth. Budget deficits, especially the quality of government spending and taxation, can affect these. For example, to the extent that a tax rate cut is viewed as growth-oriented, it may strengthen the currency, lower the inflation expectations, and lead to lower interest rates. We saw this phenomenon in the 1980s.

When inflation, or expectations of future inflation, rise, so will interest rates regardless of the size of government borrowing. I expect long-term U.S. interest rates to rise during 2003, but not because of increased government borrowing. Rather, the private demand for credit should rise as the expansion gains traction, putting upward pressure on interest rates. In this case, higher interest rates would be a good sign for the economy, since it would be the result of robust growth. It would not be a constraint on growth as many contend.

Treasury Note Yields and CPI Inflation



Source: CBO; Bear, Stearns & Co. Inc.

It is important to note that the empirical data do not show a relationship between interest rates and the budget deficit. This makes sense. The U.S. is part of a global capital market. Government debt is only a part of the demand on the global capital base. For example, at the end of the third quarter of 2002, the total stock of outstanding debt in the U.S. (public and private) totaled about $20.4 trillion, of which $16.7 trillion had been issued by private-sector borrowers and $3.7 trillion by the government. When you consider government debt, the world's seven largest governments alone have issued roughly $12 trillion of debt, of which less than a third has been issued by the U.S. government.

The Administration's tax cut proposal is projected to add about $67 billion per year to the federal government's deficit over the next ten years. This amount of additional borrowing will add only 0.3% to the stock of outstanding global public and private sector debt (ignoring private foreign borrowing and other capital market demands like equity issuance). It is hard to see how such a small increase in the debt outstanding can push interest rates up enough to hurt the expansion.

Consider the recent experience of the U.S.:

- The yield on 10-year bonds fell throughout the 1980s, even as the fiscal deficit moved above 4% of GDP over a number of years.
- The August 1993 tax hike was followed by an increase in 10-year bond yields to nearly 8% by November 1994 from 5.5% when the tax hikes were passed.
- Note yields rose to 6.7% by early 2000 from a low of 4.5% in late 1998, even as the budget was producing surpluses.
- Note yields have fallen despite the return of the deficit over the past two years.

Longer-Term Stimulus Ideas

The Administration's tax proposal will, in my view, provide substantial near-term and long-term stimulus for the economy. Reducing the distortion in the U.S. capital structure will boost the U.S. growth rate.

Other important reforms, in my view, should cover the tort system, the tax code, social security, and Congress's scoring system (which causes a strong bias toward bigger government).

On the international side, we should recognize the importance of currency stability, growth-oriented IMF reforms to end its bias toward austerity and impoverishment, labor flexibility in Europe, and a non-deflationary monetary policy for Japan. In combination, these policies would create more prosperity abroad, encouraging U.S. exports and reducing some of our national security burdens.

Chairman NICKLES. Mr. Malpass, thank you very much.

Next we will hear from Michael Baroody. He is the executive vice president of the National Association of Manufacturers and serves as chairman of the Asbestos Alliance Steering Committee. The National Association of Manufacturers has 14,000 member companies and subsidiaries. In addition to that, Mr. Baroody has an impressive background that includes serving as Assistant Secretary at the Department of Labor and also as the Deputy Assistant to President Reagan.

Mr. Baroody, welcome to the Committee.

STATEMENT OF MICHAEL E. BAROODY, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. BAROODY. Thank you very much, Chairman Nickles, and Senator Conrad and members of the Committee.

As the Chairman indicated, I am here to testify both for manufacturers and the NAM and for the Asbestos Alliance we lead. I would like to try to summarize the formal testimony that I have submitted and ask that the studies I attached to that formal submission be included in the record. Those are studies that look at the asbestos litigation crisis. I also attached a copy of the NAM's pro-manufacturing, pro-growth policy agenda that we would recommend to the 108th Congress.

I would like to summarize emphasizing three major points.

First, American manufacturers are on the leading edge of the most intense global competition in history, which, put simply, makes it impossible to raise prices. That means that if costs rise for whatever reasons, including congressional action or inaction, while we can't raise prices and costs go up, something has got to give. Regrettably, in the past 2 years, despite the fact that we have the best workers in the world in manufacturing, it was the people who make things in America who had to give, and they had to give too much as we lost 2 million jobs in American manufacturing.

Second, the overall economy—and, more specifically, the manufacturing economy—is growing currently too slowly to reverse this trend, far more slowly than in any comparable recovery period in the post-World War II era. In fact, the recent recession was unique in that manufacturing led into the slowdown and currently lags in the recovery opposite from the pattern of previous recessions.

In December of 2000, as the recession in manufacturing became apparent to us, the NAM called for pro-growth policy, including pro-growth tax relief. Now that the manufacturing slowdown has proven so durable, we repeat the call more urgently than ever, in the conviction that manufacturing remains central to the strength of the American economy and its prospects for future economic growth and as central to our national security as to our economic security.

Third, Mr. Chairman, there is a need to look at obstacles to growth. I have in mind among them the well-documented burden of excessive regulatory and legal compliance costs which together accumulated to an estimated $700 billion last year. On the regulatory side alone, these burdens tend to fall disproportionately on manufacturers, so much so that the regulatory costs per worker in manufacturing is estimated at $8,000 per employee, about two-thirds more than the burden on it per employee in the general work force. While the costs of the legal system are borne broadly throughout the country, there is one egregious example: the asbestos litigation crisis—it is a scandal, really—that has fallen especially hard on manufacturers. I would like to elaborate on this last point first and then return briefly to my other two before concluding this summary.

Over its history, asbestos liability has bankrupted more than 65 companies, more than 20 of them in the past 2 years. Though most of the companies which made asbestos products and mined it are in bankruptcy, the list of defendant companies continues to grow. A preliminary Rand study last fall offered an estimate of 6,000 defendants. Last week, that estimate was revised upward by 40 percent. It is now 8,400 defendant companies.

By any common-sense standard, many defendants who were made to pay, and sometimes paid to the point of bankruptcy, haven't harmed anyone. They are guilty only of being a solvent and usually an insured defendant. I have in mind, for one example, Mr. Chairman, a small Midwestern manufacturer of industrial air compressors. The company employs about 100 workers. Its compressors contain no asbestos, and it knows of no way that their use could have exposed anyone to asbestos. Yet they have been sued in multiple cases in multiple courts. And, worse, as for the plaintiffs, by any similar common-sense standard most of them aren't sick. Again, Rand estimates that anywhere from two-thirds to 90 percent of all claimants are "functionally unimpaired, meaning that their asbestos exposure has not so far affected their ability to perform activities of daily life."

What we have, Mr. Chairman is a massively dysfunctional system that forces many companies in cases where they aren't liable to compensate people who aren't sick. That dysfunctional system hurts people. It creates many victims and many classes of victims, and first among these victims are the people who really are sick. Yet often they are forced to wait for years for compensation that is inadequate, and it is inadequate because the awards going to people who aren't sick are depleting the resources that ought to go to compensate people who are.

To illustrate the dysfunction, there is the case of the widow of a shipyard worker, widowed because of his fatal asbestos illness. Her only recourse was to sue several companies. She reports that most of them filed bankruptcy in the past 2 years, and she can expect to receive only a fraction of the compensation she might have expected pre-bankruptcy, perhaps a few thousand dollars. Contrast that with the notorious October 2001 Mississippi case where a jury awarded $150 million to six plaintiffs, $25 million each, about whom their lawyer boasted that "Most of these guys have never missed a day of work in their lives."

As for fairness in that, one member of the asbestos trial bar who favors reform, as we do—and there are many of them—testifying last September before both then-Judiciary Committee Chairman Leahy and now Chairman Hatch, concluded by urging Congress "to act quickly to fix this broken and abused part of our justice system before the real victims of asbestos lose everything."

If sick people and their families are the first victims of the system, they are not the last. There are thousands of economic victims, including people whose jobs are lost or threatened, whose retirement savings are depleted, and whose communities are diminished and economically shaken by the effects of massive asbestos liability burdens that hang over the companies they work for. One of the defendant companies in the Mississippi case I just mentioned is now bankrupt. Its total liability added up to more than the company had made in profits in its entire 40-year history.

Another company saw 42 percent of its market value, $3.8 billion, disappear in a day because of financial market concerns about its asbestos liability.

Thus far, $54 billion has been spent on this, and several estimates of the present and future liability if the asbestos litigation system isn't reformed exceed $200 billion and range as high as $275 billion.

The Nobel Prize-winning economist Joseph Stiglitz completed an excellent study last year of the economic consequences, and particularly on workers, of this asbestos crisis. Put briefly, he found that 60,000 workers had lost jobs because of bankruptcies; that these workers and their families had lost $200 million in wages because of this; and that workers at bankrupt companies had seen their retirement 401(k) savings drop by an average of 25 percent. When the study was released, I characterized its findings to mean that what we have seen so far was ugly, and we ain't seen nothing yet.

Rand, for example, says the eventual costs could exceed 400,000 jobs, and if the system remains unreformed, the number of bankruptcies could grow with concomitant loss of jobs and wages, market valuation retirement savings, and community economic activity and well-being.

Mr. Chairman, that takes me back to where I began. The overhang of asbestos liability is huge, and it adds to costs at a time when we can't raise prices. I have called a $250 billion anchor of present and future liability that American industry has to drag as it strains to participate in this recovery. What we need instead of that anchor is the wind at our backs—in other words, more growth. Manufacturing remains today at the leading edge of productivity, innovation, and technology. Most of the R&D done in America, for example, is done in manufacturing. We are challenged as never before—by the effects of global and domestic economic slowdown and geopolitical certainty, the export-depressing effects of an overvalued dollar, the return of double-digit health care cost inflation, and other substantial changes.

Mr. Chairman, a concluding thought. The state of the economy is our subject, and we are always in danger of assuming too much about its capacity to withstand such problems and costs as the asbestos crisis represents because—well, because it has withstood so many challenges in the past and continued to grow despite them and to prevail in global competition. The cumulative weight of these problems can overwhelm even a $10 trillion economy and sorely test even the considerable strengths of modern American manufacturing. This Congress could make a good start at dealing with them and invigorating economic growth by passing tax relief of the sort proposed by President Bush, which the NAM strongly supports, by constraining Federal spending, by doing no harm when it comes to adding regulatory and other costs to the conduct of business in America, and at long last, by responding to repeated urgings from the Supreme Court and elsewhere with a solution to the asbestos litigation nightmare.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Baroody follows:]

Testimony of

Michael E. Baroody
Executive Vice President
National Association of Manufacturers

and
Chairman
Asbestos Alliance

Before the
Committee on Budget
United States Senate

On
The State of the Economy

January 29, 2003

Thank you Mr. Chairman and Members of the Committee. I am executive vice-president of the National Association of Manufacturers and chairman of The Asbestos Alliance Steering Committee. In the first part of my testimony, I speak on behalf of the Alliance, a coalition led by the NAM that includes asbestos defendant companies, insurers, trade associations, and others seeking congressional legislation to help solve America's asbestos litigation crisis. While this hearing is not about asbestos litigation per se, I believe its far-reaching impact is one of a number of factors hurting the U.S. economy. In fact, I would characterize out of control asbestos litigation as an anchor weighing down the business community, particularly the manufacturing sector, and slowing down our overall economic recovery. Let me explain why.

For the last 18 months, newspapers and magazines have been filled with stories of skyrocketing claims, massive jury awards and bankruptcies. Asbestos litigation has already forced more than 60 companies into bankruptcy. More than one third of those bankruptcies have occurred in the last three years. An estimated 200,000 claims are now pending. More than 90,000 were filed just in 2001, the last year for which complete data are available. Moreover, we are not by any means near the end of this story. According to some estimates, after more than 25 years, we have not yet passed the halfway mark. Ultimately, if nothing is done, we may see more than two million asbestos cases, and the ultimate cost to American business could reach $275 billion.

It would be a different matter altogether if this huge sum was the amount needed to compensate people with deadly cancers and other serious diseases caused by exposure to asbestos. But in fact, exactly the reverse is true. The heart of the problem is that asbestos claimants who are not sick today and who probably will never become sick are filing claims and winning millions of dollars. According to a report released last year by RAND, between 2/3 and 90% of all claimants are "functionally unimpaired, meaning that their asbestos exposure has not so far affected their ability to perform activities of daily life."

Let me give you an example of why this is a problem. In October 2001, a Mississippi jury awarded $150 million to six plaintiffs in an asbestos case. Each was awarded $25 million. Not one of these six men displayed any symptoms at all. In fact, the lawyer who brought the case boasted to reporters, "Most of these guys have not missed a day of work in their lives." One plaintiff even boasted in his deposition that he was a jogger.

Questionable claims like the ones in this case and the resulting settlements and verdicts are forcing companies into dire financial straits and sparking the bankruptcy filings. One of the defendants in the case I just mentioned is now bankrupt, and another saw 42% of its market value, $3.8 billion, disappear in a single day because of the financial markets' concern with asbestos liabilities. At the same time, many of those who are seriously ill from exposure to asbestos are seeing their compensation delayed and reduced. If the present course continues, there may not be any money left to pay the sick.

There are many victims of this asbestos litigation scandal, but first among them are the truly sick and their families, who may have to wait for years for inadequate compensation. For that reason, prominent plaintiffs' lawyers who represent cancer victims actively support the Alliance's proposed reforms. But there are other victims as well.

According to RAND, in 1970, there were 300 companies in asbestos litigation. Today, that number is 8,400 companies, representing virtually all U.S. industries and companies of all sizes. Many of the defendants never even made or used asbestos in their products. These range from well-known Fortune 500 multinationals to tiny firms, like a five-person company that distributes air compressors to gas stations. That small business is still trying to determine why it has been named in asbestos lawsuits!

The defendant companies are spending untold millions of dollars and resources. A total of $54 billion has been spent on asbestos litigation and, as I mentioned above estimates of total cost range as high as $275 billion. The workers in the many impacted companies, retirees and shareholders are also paying a heavy price. Late last year, Nobel Prize-winning economist

Joseph Stiglitz did an excellent study on the impact of asbestos bankruptcies on workers. I would like to share some of his findings.

Dr. Stiglitz found that asbestos bankruptcies have put 60,000 employees out of work. Those workers and their families have lost $200 million in wages alone. Employee retirement assets have declined roughly 25%. And the direct costs of bankruptcies on the bankrupt firms have been between $325 million and $625 million. These companies, their employees, and the communities that depend on them are also victims of asbestos litigation.

While the report did not focus on the non-bankrupt firms, the authors noted that uncertainty surrounding asbestos claims raise borrowing costs and reduces equity values of solvent firms, which has a significant impact. The mere fact that a company is the target of asbestos claims—as so many are—can throw its stock into free fall. For example, when a large company announced last year that it had about 3,000 claims, its shareholders lost about 25 percent of the value of their holdings almost overnight. Only a portion of that value was regained in subsequent months.

Just last week, we received even more disturbing news about the economic impact of asbestos litigation. A U.S. Chamber of Commerce-sponsored study by National Economic Research Associates Consulting found that nationwide, there will be as much as $2 billion in additional costs borne by workers, communities and taxpayers due to indirect and induced impacts of company closings related to asbestos. The shuttering of plants and job cuts will decrease per capita income, lead to declining real estate values and dwindling federal, state and local tax receipts. Additional costs brought upon workers and communities include up to $76 million in worker retraining, $30 million in increased healthcare costs and $80 million in payment of unemployment benefits. In addition, for every 10 jobs lost directly, the community may lose 8 additional jobs.

The evidence is simply overwhelming—we are all paying the price of the asbestos litigation crisis and something must be done. Last year, your colleagues in the Senate Judiciary Committee held an asbestos hearing and both then-Chairman Leahy and new Chairman Hatch agreed that congressional legislation is essential to resolve these problems. Steve Kazan, a prominent plaintiffs' attorney was among the witnesses and he concluded his testimony by saying, "I urge you to act quickly to fix this broken and abused part of our justice system before the real victims of asbestos lose everything. Only Congress has the power to end this national nightmare." The members of The Asbestos Alliance could not agree more. We are working diligently with the Senate and House to try to get legislation passed this year. It is essential not only to ensure that the sick and dying obtain the compensation they deserve, but also to protect the other victims of asbestos litigation – shareholders, employees, and communities that are injured when companies are made the targets of thousands of frivolous lawsuits.

Lifting this burden from the neck of American business would contribute enormously to economic recovery. Without the asbestos albatross, the thousands of affected firms would be more likely to increase profits, expand their business, make capital investments and create jobs. Reform is also likely to stop the flood of asbestos bankruptcies. These impacts would almost certainly increase federal tax revenues, reduce unemployment claims and help resolve the country's budget problems.

Let me turn now more broadly to the state of the economy, and more specifically, to the state of the manufacturing economy. On these issues, I speak not for the Alliance, but on behalf of the National Association of Manufacturers. NAM is the nation's largest industrial trade association and represents 14,000 members, including 10,000 small- and mid-sized companies.

The recent economic downturn hit manufactures much harder than the rest of the economy both in terms of depth and duration. Manufacturers began slipping into recession in the third quarter of 2000 – well ahead of the rest of the economy. And by the time that manufacturing output began to turn up in the beginning of 2002, industrial output had fallen by 8 percent over the previous 18 months. This is much worse than the rest of the economy. Overall, GDP slipped less than half a percent during the first three quarters of 2001 -- the second-mildest recession in 50 years.

And while the overall economy grew a modest 3 percent last year, manufacturing output edged up only 1.7 percent[1]. This manufacturing "recovery" is slower than the first year of any recovery over the past 40 years and less than one-fifth the average 10 percent growth during the initial 12 months of the past six expansions.

Since July 2000, manufacturing employment has fallen by 2 million over the course of 29 consecutive monthly declines. By contrast the employment in rest of the economy has grown by

954,000, with a brief, but sharp drop in employment immediately following September 11th sandwiched between months of modest employment growth.

During the manufacturing downturn that began in June 2000 and ended 18 months later in December 2001, 1.4 million manufacturing jobs were lost. This 8 percent decline in manufacturing employment rolls matches the average decline during the past six recessions. However for 2002 overall, another 592,000 manufacturing jobs were lost. This stands in stark contrast to the average 352,000 increase in manufacturing employment that typically has taken place during the first year of previous expansions and clearly shows that the recovery has largely bypassed the manufacturing sector, which was hit hardest in 2001.

To date, the largest employment declines by far have taken place in the electronics and industrial equipment industries. Each has lost more than 350,000 jobs and together account for more than a third of the manufacturing job losses since mid-2000.

The reason why manufacturing was hit much harder than the rest of the economy in the recession and why the recovery has evaded manufacturers is that the recession was mainly caused by a collapse of business investment and exports, which declined by 9 percent and 11 percent respectively in 2001[2]. By contrast consumer spending held up reasonably well, growing by 2.8 percent in 2001.

[1] NAM GDP estimate based on published data through the third quarter and a fourth quarter projection.
[2] Q4/Q4 percent change.

More recently, the 2002 recovery was largely driven by consumer spending, which accelerated modestly to 3 percent growth last year.[1] At the same time, business investment spending continued to decline by 3 percent, while goods exports edged up just 2 percent (remaining 8 percent below their level two years ago). This stands in stark contrast to 10 percent growth in exports during the first year of recovery following the 1990-91 recession.

Weak business investment demand and export growth have constrained the recovery for manufacturers, the producers of capital goods used by American industry and the source of two-thirds of overall exports. In short, the expansion to-date has been narrow, unbalanced and historically sluggish.

Despite historically low interest rates, and a bonus depreciation stimulus package passed last year, significant inhibitors to economic growth remain. Some of the challenges facing manufacturers are long-term problems that need to be addressed to create a better environment for manufacturing in America.

- Manufacturers are competing in a deflationary environment, with pricing power *falling* at an average annual rate 0.9 percent since 1995. By contrast, the inflation rate for the economy overall has averaged 2 percent since the mid 1990s.

- At the same time, heavy regulatory and legal costs are undercutting business competitiveness. Combined, a heavy regulatory and legal burden cost U.S. firms $697 billion, or 6.7 percent of GDP, in 2002.[3] Manufacturers are especially hard hit. The cost of regulatory compliance alone adds up to $8,000 per manufacturing employee. This is 67 percent higher than the average cost to business overall.

- Manufacturers' healthcare costs rose at an average rate of 13 percent over the past year.

- 80 percent of NAM's membership found a moderate to serious shortage of qualified applicants in 2001. This signals that a persistent skills gap remains a problem for manufacturers.

- U.S. share of world manufactured exports has fallen from 13 to 11 percent since 1997 due to the rise in the value of the dollar. And while the dollar has fallen since its peak last February, it still remains 15 percent above its historic level.

Businesses have also become increasingly uncertain about the short term outlook, evidenced by the fact that the ISM business activity index dropped 9 percent from May to December 2002. This lack of confidence has curtailed investment spending, which is the main reason why the current recovery has underperformed past recoveries.

Businesses confidence has been undercut since the final quarter of the 2001 recession for a number of reasons.

[3] NAM estimate based on reports by the Council of Economic Advisors and the Small Business Administration

- First, the attacks of September 11 and the entry of our nation into a war on terrorism have created an elevated degree of uncertainty in the nation overall.

- Second, the emergence of several major financial scandals in 2002 undercut consumer confidence and sent the Dow Jones Industrial Average plummeting 32 percent between March and October 2002. As a result, consumer confidence fell to a 9-year low by October 2002. So, despite healthy growth in real incomes throughout 2002, consumer uneasiness deepened. This dichotomy has caused businesses to put on hold their spending plans for the fear that expected demand may not materialize.

- Third, the probability of a war in the Middle East, and its possible effects on world oil supplies and prices has further elevated both business and consumer uncertainty.

At the same time, some important fundamentals of the economy have improved and have primed the economy for faster growth once uncertainty dissipates.

- First, there has been a steady and strong acceleration in productivity and associated gains in real incomes in 2002. By the third quarter of 2002, business productivity growth was 5.6 percent higher than a year earlier – the fastest quarterly growth rate in 36 years. This increase in productivity has, in turn, increased real wages. During the first three quarters of 2002, real disposable income grew 3.9 percent over the previous year. This is more than double the modest 1.8 percent growth in 2001 and is a solid foundation for consumer spending going forward once confidence improves.

- Second, this rise in productivity has rapidly pushed down unit labor costs, which has, in turn, led to a recovery in profits. In fact, for the first time since 1949, the labor cost per unit of output has declined four quarters in a row beginning in the 4th quarter of 2001.

  As a result, corporate profits have begun to make a recovery. Manufacturing profits declined by $75 billion from the third quarter of 2000 to the first quarter of 2001. By the third quarter of 2002, nearly two-thirds of this decline was recovered. Similarly, after dropping $138 billion between the fourth quarter of 1999 and the third quarter of 2001, overall corporate profits have rebounded 60 percent.

  This recovery in business profits should prop up business investment spending and counter some of the general uncertainty that continues to exist in corporate America.

- Third, though it still remains 14 percent above its 1997 value, the dollar has depreciated 9 percent since February 2002. This, combined with slightly faster expected economic growth abroad in 2003, should prop up an export recovery which, to date, has been very modest. However, further depreciation is needed for manufacturers to regain their international competitiveness.

- Fourth, after inventory levels reached a five-year high in mid-2001, manufacturers aggressively worked off excess stocks over the past year. Manufacturers' inventory-to-sales ratios are now near a decade low. This means that firms will respond to stronger demand with increased production since inventory stocks are lean.

Increased uncertainty and an improvement in the fundamentals will work at cross purposes in 2003. While real income growth should keep consumer spending on track, this could be derailed by further shocks to confidence. As a result, businesses will continue to hold back spending plans. Therefore, an acceleration in the economic recovery will not likely take place this year without significant fiscal stimulus to counter the threat of uncertainty. This has important ramifications to the manufacturing sector. Without a meaningful pickup in business investment spending, an upturn in the manufacturing recovery will continue on hold.

NAM strongly supports President Bush's economic growth plan because it offers a creative mix of incentives that will encourage aggressive investment in the stock market and new capital investment by business, which will create more jobs. Specifically, the proposal to eliminate double-taxation of dividends will boost business and consumer confidence, reduce the cost of investment capital and encourage business to invest more in new plant and equipment.

Small business will especially benefit by the proposal to increase the allowance for expensing capital investments from $25,000 to $75,000, indexed to inflation. This will provide a powerful incentive for small manufacturers to increase investment and create jobs.

NAM also endorses the President's support of regulatory and legal reforms as a critical key to stimulating the economy and creating jobs. Removing unnecessary impediments to growth is as important as providing economic incentives.

Addendum to the
Testimony of

Michael E. Baroody
Executive Vice President
National Association of Manufacturers

and
Chairman
Asbestos Alliance

Before the
Committee on Budget
United States Senate

On
The State of the Economy

January 29, 2003

The NAM's Pro-Manufacturing Agenda for 2003

American manufacturing is innovative, productive and efficient. For decades it has been the center of the strength of the American economy and its prospects for future growth. With the best workers in the world, technologies that are on the global cutting edge and R&D efforts capable of keeping it there, manufacturing in America made this country the world's high-quality, low-cost leader in a wide variety of products and made the U.S. the largest goods exporter in a world marked by the most intense global competition in history.

Yet currently manufacturing is at a crossroads -- it lags the rest of the U.S. economy and its recovery from recession is slow. The recession itself, unlike all previous post WWII downturns, uniquely affected manufacturing and caused the loss of two million manufacturing jobs. There are many reasons for this including geopolitical uncertainties, the ongoing war on terrorism and slow economic growth worldwide.

In addition to global uncertainty, however, there are factors contributing to the manufacturing slowdown that require policymakers' attention and which, if appropriately addressed, can do much to reinvigorate manufacturing, stimulate more robust and durable growth and increase employment:

- American manufacturing is at a distinct disadvantage in global competition due to unfair trade practices, export constraints and artificially distorted currency values, such as in China where the currency is undervalued as much as 40 percent.
- Intense foreign and domestic competition makes it impossible for American manufacturers to raise prices for their products, fatally compromising their ability to meet

rising costs associated with government regulations, runaway litigation and employee health insurance.

- Accelerating technological change could make it increasingly difficult to achieve high productivity growth because of inadequate capital investment and workforce skill deficiencies.

To deal with these issues, strengthen the economy and encourage growth, the NAM will pursue the following policy agenda in 2003:

Taxes: To encourage capital investment, productivity and job creation, there should be further acceleration of depreciation and reduced taxation of dividends. The tax relief enacted in 2001, including estate tax repeal, should be made permanent and the scheduled marginal rate cuts accelerated. The ongoing impasse with the European Union over the World Trade Organization ruling on taxation of extraterritorial income (the FSC/ETI case) must also be addressed, and further reforms in the international tax arena should be enacted to enable U.S. companies to effectively compete in the global marketplace. We also need a permanent R&D tax credit that benefits the largest number of companies and pension reforms to encourage greater participation in the private retirement system. Finally, to ensure that these tax law changes benefit all manufacturers, action is needed to repeal the corporate alternative minimum tax (AMT), the "anti-manufacturing tax."

Trade: Changing global competitive conditions must be a priority. The U.S. must insist that foreign markets become open and trade must follow global rules. The U.S. should advance the WTO Doha Round, including the "zero-tariffs" proposal, a Free Trade Agreement of the Americas Agreement and additional bilateral trade agreements. U.S. policy governing export controls and unilateral sanctions must be modernized and an exchange rate regime should be promoted that is based on economic fundamentals and the free operation of markets. Given the rapidly rising importance of China in world trade, the Bush Administration should seek a particular commitment from China to the market valuation of its currency.

Training and Skills: Jobs in American manufacturing are among the best jobs in the world. They are rewarding; they are also increasingly demanding of skills. Both the workers of today, and tomorrow's workers now in school, need improved systems of education and training through stronger implementation of the Workforce Investment Act, improved vocational education and a strengthened, reauthorized Higher Education Act.

Technology: Most R&D is in manufacturing, our key technological and economic advantage. We can preserve and enhance it with improved tax treatment of R&D expenditures, stronger protection for intellectual property in a globally competitive environment, adequate funding of federal science programs and a strong patent system.

Reform of the Health Care System: Increased federal mandates and liability exposure for employers will raise costs and reduce insurance for workers. Policy-makers should focus on lowering costs through improved quality and greater access to health care for all Americans, and work to reform Medicare in a way that allows addition of a prescription drug benefit to a strengthened program. Reform of medical liability law must also be a priority.

Asbestos Litigation Reform: The current system is dysfunctional, compensating people who are not sick at the expense of people who are, bankrupting companies in the process and threatening jobs and retirement savings of hundreds of thousands of manufacturing workers. Medical criteria legislation, like that advanced by the NAM's Asbestos Alliance, is urgently needed.

Reform of the Legal System: A durable priority for manufacturers, reform of the legal system can be advanced in the 108th Congress. Prospects for class action reform and medical malpractice legislation, among others, can be furthered by widespread manufacturing participation in the NAM's FLAG program (the Fair Litigation Action Group) designed to enable member companies to inform and enlist their workers in the effort to hold members of Congress accountable for enacting needed reforms.

Energy Policy: Enactment of a balanced, comprehensive, national energy policy is overdue and is essential to ensuring durable and sustainable economic growth in manufacturing and the broader economy. Reliable supply at affordable prices, increased efficiency, strengthened infrastructure and investments in R&D and new technologies are each essential elements of sound policy. Recognition of the mutual benefits to all three partners of greater cooperation in a NAFTA energy alliance holds much promise. The NAM supports the President's climate research and voluntary greenhouse gas reduction initiatives, but opposes mandatory greenhouse gas reporting. The NAM vigorously opposes the Kyoto Protocol and any domestic actions leading to quotas or caps on fossil energy use by utilities or by industry.

Environment: The U.S. must continue making environmental progress while maintaining economic growth in the competitive world marketplace. To achieve these dual goals, environmental policy must continue to evolve from decades-old command-and-control prescriptions to approaches that encourage innovation, investments and partnerships. When environmental regulation is necessary, rules must be based on sound science and accurate data, and allow maximum flexibility to meet performance standards by using the most cost-effective means. Specific priorities for the manufacturing community this year include New Source Review (NSR) reform, sensible multi-emissions legislation and science-based air quality standards.

Transportation: Just-in-time operations are a vital component of modern manufacturing. Just-in-time is based upon a reliable and satisfactory transportation infrastructure. The NAM supports adequate investment in our transportation infrastructure, especially the need for improved intermodal connectors and facilities as well as other improvements to make freight travel more timely and efficient.

Chairman NICKLES. Mr. Baroody, thank you very much.

Our next witness we have is Mr. Gene Sperling. I think most of us know Mr. Sperling. We had the pleasure of working with him during his role advising the Clinton administration. He was the White House National Economic Advisor, and he also served as Director of the National Economic Council. Currently, Mr. Sperling is a senior fellow for economic policy and Director of the Center of Universal Education at the Council on Foreign Relations.

Mr. Sperling, welcome.

STATEMENT OF GENE B. SPERLING, FORMER NATIONAL ECONOMIC ADVISOR AND DIRECTOR OF THE NATIONAL ECONOMIC COUNCIL

Mr. SPERLING. Thank you, Mr. Chairman, Senator Conrad, the rest of the Committee. I will do my very best to summarize my remarks, my testimony; if I read it, I would probably go longer than President Bush did last night.

Chairman NICKLES. Thank you.

Mr. SPERLING. I really want to focus in on two things, which are: one, what I believe is the short-term economic policies we need to stimulate demand and restore growth; and then, second, why I believe that the long-term focus on fiscal responsibility is an essential component to growth in the degree that it increases savings and capital and, I believe, leads to the type of sustainable growth and virtuous cycle that I think our country benefited from in the 1990's.

Let me start on the need for economic stimulus. There are several things Mr. Malpass said that I agree with. Consumers unquestionably were the economic hero in 2001, I think for a variety of reasons. I think the significant income gains that we have seen in the last half of the 1990's and productivity have carried through. I think people saw their housing values staying high, and so I think there is no question that the consumer response was stronger than anyone expected. I also agree with him that outside of construction, aircraft, and telecom, there were some industries that certainly moved into growth on the investment side.

The reason why I disagree, though, about the need to have a sharp degree of demand stimulus right now is that, one, I believe that for us to count on that consumer demand being there would be very unwise. Help-wanted index, at a 40-year high; we have lost 2.35 million private sector jobs in the last 2 years. Yesterday the consumer confidence went to its lowest level since November 1993. In other words, consumer confidence is lower today than it was in September and October of 2001 after 9/11. In terms of investment growth, some companies certainly—industries are picking up, but look at a Business Council survey that showed that 78 percent of major companies are planning on reducing or maintaining their investment levels. Capacity utilization stays at 74 percent, 61.7 percent in the high tech. So I think that we do face a far greater risk of a negative downturn in which the perception of less demand could keep more companies sitting on the fence, and that this could lead to a negative cycle. So, in a sense, when one supports stimulus, one supports essentially an insurance policy against that type of negative cycle downward.

Now, I believe if you are going to do a stimulus, it should really have two fundamental principles. I respect those who disagree that you need any kind of stimulus. If we are going to talk about that, it should be about how you inject as much demand as possible into this period of time when we fear weak demand will lead us in this downward cycle. Therefore, you fundamentally want to do a "bang for the buck" test. How much of the stimulus is likely to inject more consumer spending and business spending in the time that we are trying to focus on? So, therefore, my test has been how strong is the "bang for the buck" analysis and how much can we do this without having long-term costs on our deficit in the long term.

Now, my opinion is that so far we have not served our country well with the forms of stimulus we have done. If you look at the consumer demand elements, we did get an advance of the 2001 tax cut at the 10-percent level into the fall of 2001. We left out the 34 million families at the bottom who would have had the highest propensity to spend. While, Chairman Nickles, I congratulate you and Senator Clinton for making progress on unemployment, the people who get unemployment insurance are among those most likely to spend a high percentage of their funds and in the communities hardest hit. So, again, I don't think we have served the country well with the types of stimulus that we have done so far.

Second, on the business incentives, the goal on the business incentives for stimulus, as opposed to our different strategies for long-term growth, is to take measures that accelerate investment into this time period. Therefore, I supported having a very strong, 40-percent depreciation bonus last year, but just for that year. What we passed was a 30-percent depreciation bonus, but it lasts for 3 years. That is a little bit like a store saying we have a special deal this weekend, 50 percent off; oh, but, by the way, you can get the same deal 2 months from now, 2 months after, 2 months after that. Nobody would rush to the store to buy in that circumstance.

What we wanted to do was say to those companies who were sitting on the fence, we want you to accelerate your investment now, and so in doing that you offer temporary incentives that makes companies feel that they need to accelerate investment up in addition. Again, by doing a 3-year plan, we encouraged anybody sitting on the fence to keep sitting on the fence, because you could get the same incentive in 2004 that you could by accelerating investment right now. Again, I don't think we have served our country well because we have not seen, I think, the effectiveness of that stimulus.

Finally, we heard warnings from both Democratic and Republican Governors that States were hurting. Now, just from a simple point of view, $1 of stimulus at the Federal level will be canceled out by $1 of tax increases or spending cuts at the State level. So it has not made sense for us to have a plan that did not deal with the State contraction that they are going under.

Now, let me stress, I am not for a complete bailout of States. I think that would create a moral hazard situation. I think you want States to feel that they are not going to be fully bailed out when they run through the rainy-day funds. Again, I believe we could be doing significantly more without coming anywhere near that problem, especially in light of the fact that States are facing the additional challenge of homeland security.

So, quite simply, as my testimony says, I think that we should focus on consumer demand that is highly targeted to getting spending out in 2001. I think we should assist the States. I think the business incentives should be temporary. I would recommend that the Administration and Democrats compromise on a plan that is limited to costs in 2001—excuse me, 2003, that doesn't have long-term costs, but you could take a mixture of Democratic ideas and things like increasing the child tax credit or expensing, as President Bush proposed, but limit the cost to 2001. Now—excuse me, 2003.

Now, I think going to our long-term situation, one of the great debates that we are having right now is on what should be the importance of long-term fiscal discipline. If I was speaking earlier, I don't think I would have to even start with this case. In the mid-1990's, we debated how to balance the budget, how to have fiscal discipline, not whether it matters economically. In the late 1990's, there was a bipartisan agreement that the Social Security surpluses should be fundamentally saved.

I want to just kind of mention why I believe the seven reasons that fiscal discipline should be very important, and as I look at my clock, Mr. Chairman, I realize that I am going to have to go briefly.

No. 1, fiscal discipline was fundamental to the increase in national savings in the 1990's. Our private savings rate, regardless of whether it is calculated right, certainly moved in the wrong direction. The full increase in our net national savings came from the improvement in our Federal fiscal position. All of our national savings improvement came from fiscal discipline.

Second, the fiscal responsibility promoted a strong long-term investment climate through low interest rates and increased confidence. As Harvard's Martin Feldstein said, "An anticipated future budget deficit means a smaller amount of funds at the future date to finance investment in plant and equipment. Restricting that investment will require a higher rate of interest." I think that the point that we have to focus on, and which Peter Orszag and Bill Gale have done so, is what is the impact of anticipated deficits on interest rates. A company that is going bankrupt on asbestos may not see their stock value go down dramatically the day somebody walks in to file the papers. I guarantee you the moment that markets anticipate the expectation that the company may be going into bankruptcy, I guarantee you their stock market goes down. Therefore, one has to analyze what is the expectations of deficits on long-term interest rates, and their study says that when you look at that, you find 92 percent of studies do show this very strong link.

Let me mention a couple of final things, as I am running out of time, which is, one, the question has been raised: Do surpluses create growth or growth create surpluses? That is the wrong question. The question is: What is the best fiscal policy that encourages a sustainable degree of economic growth in which, as the economy heats up and there is a greater demand for capital, we do not hit the wall of inflation or capacity, but we continue to have an environment that seeks additional investment? The magic of the 1990's, the virtuous cycle, was that as the economy strengthened, the improvement in the fiscal situation created more capital and savings for the private sector. Instead of crowding out the private sector, as Senator Conrad fears, we actually crowded in more capital by paying down the debt. That should be our question: Which are the policies that lead to greater fiscal—lead to great sustainable growth?

The last point I want to make is one that I think is missed much too often. I heard the OMB Director say yesterday that with the stimulus policies the Administration is proposing, the deficit may be $300 billion, and that that is OK because that is within 3 percent of GDP. I agree that temporary deficits to stimulate the economy, and particularly to fight a war, is justified. I also agree that if you can keep it at a relatively low level of a couple percent of GDP, that is a good place to be. The only reason we are in that position is because of the policies of savings surpluses from the late 1990's. Had we just been in a position of projected balanced budgets in 2001 and 2002, the deficit for next year would be projected to be $600 to $700 billion. It would be the largest deficit even as a percentage of GDP.

So our lesson today should be that rainy days do come. You do need to stimulate the economy. You do need to face war. That is all the more reason why the long-term fiscal discipline, once we get out of this period of economic weakness, is justified.

I clearly have much more to say, Mr. Chairman, but I fear I am already over the allotted time. So thank you.

[The prepared statement of Mr. Sperling follows:]

Fiscal Choices and Economic Challenges

Testimony of
Gene Sperling[1]

Senate Budget Committee
January 29, 2003

Chairman Nickles, Senator Conrad, members of the Committee, thank you for the privilege of testifying on the state of the economy and economic policy today.

I. State of the Economy

No one of any economic or political perspective is satisfied with the nation's economic performance over the last two years. After the longest economic expansion in our nation's history, some were tempted to believe that the business cycle had been repealed: that downturns were a thing of the past. Unfortunately, we have learned that the business cycle cannot be repealed, because human nature – and its tendency to swing to extreme optimism and pessimism – cannot be repealed.

As we all are quite familiar with now, the strong and record expansion of the 1990s was dampened and ultimately cut short due in large part to significant overcapacity in American industry, particularly in the technology and internet sectors. Such overcapacity was no doubt driven by too many managers and investors basing their business expansion decisions on excessively optimistic valuations and growth projections. As businesses sought to reduce this overcapacity – and return to cost structures that could restore sustainable profitability – business investment fell significantly, eventually hurting job growth and consumer demand.

Many, including myself, saw the economy in a race of sorts: would consumer demand stay strong enough for businesses who had successfully pared back their cost structures to perceive strong enough demand to begin expanding their investment and payrolls? If so, the hope was that the period of economic weakness would be relatively short-lived. For a while, in early 2002, it looked as if such a positive scenario was indeed unfolding. In March 2002, for example, the ISM index showed manufacturing over 55 (growth is at 50) and the new orders index (often a leading indicator) over 65.

Yet, just as the recession turned out to be relatively shallow, the so-called recovery has been even more shallow and disappointing. The ISM index – while having a good month in December – dipped below 50 from September to November. New non-defense capital goods (excluding aircraft), after showing some bright spots in early 2002, fell four out of the five months between August and December 2002. While investment has moved into positive territory in several industries outside of telecommunications and aerospace, fixed non-residential investment has continued to fall in every quarter of 2002, and in the third quarter of 2002 was 5.1% below where it had been the year before. Capacity utilization is at only 75.4% -- 61.7% for high tech sectors -- and the Business Council Survey of major company CEOs in October 2002 showed that 78% were planning on either maintaining or even cutting back investment levels.[2]

Clearly, the stalling in the business sector has begun to wear away at the labor market and consumer resilience. Unemployment has risen; private sector jobs are down 2.3 million over the last two years, and even 219,000 in just the last two months. Consumer confidence, rather than rebounding on the news of at least moderate GDP growth, has fallen this month to its lowest level since November 1993,

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[1] Mr. Sperling was former National Economic Advisor and Director of the National Economic Council under President Clinton from 1997-2001. Mr. Sperling is currently affiliated with several organizations. The views expressed today are his own.

[2] "Market Weakness Persuades US Companies to Alter Business Plans," *Financial Times* (October 3, 2002), p. 10.

lower than even the months after the September 11 attacks. According to the Bank of Tokyo-Mitsubishi index, chain store sales in November and December grew by only 0.5% from the same period a year before -- the worst holiday season growth in the index's 32-year history.

Mr. Chairman, in an economy that is fundamentally driven by the growth and innovation spurred by the private sector, we all know that public policy will never be responsible for all of the good or all of the bad. It is unlikely that public policy could have completely prevented all of the excessive acts of corporate malfeasance or herd investing that have hurt our economy in the last couple of years. The basic test for public policymakers is twofold: how do we deal with the short-term economic hands that are we are dealt, and whether our long-term policies lay positive foundations or negative obstacles to economic confidence, growth and the process of innovation and wealth creation in the private sector.

Today, I would like to focus my comments on whether policymakers are employing a fiscal policy that is optimal both for dealing with short-term economic weakness and for laying a foundation for long-term economic growth and meeting our long-term economic challenges. I believe the recipe for our economy is to implement well-targeted policies to stimulate consumer demand and accelerate business investment in the short-term, while maintaining the long-term fiscal discipline that, by increasing savings and the supply of capital and providing confidence, ensures a strong long-term investment climate. Unfortunately, I fear that recent public policy has under-performed on both counts. On the one hand we have done too little to provided needed stimulus to the economy now. On the other, we have done too much to undermine our long-term savings, threatening confidence and our long-term investment climate.

II. Effective and Efficient Stimulus

Mr. Chairman, while it is possible that the economy will recover without additional fiscal stimulus, the evidence of economic weakness and uncertainty seem strong enough to me to justify a temporary increase in the deficit to stimulate the economy as an insurance policy against a negative economic cycle taking hold. Such fiscal stimulus, however, is advisable only under two conditions. First, it must be done in the most efficient manner possible – the so-called bang for the buck calculation. This means we ensure as much of the cost of such a stimulus as possible be geared toward increasing consumer and business demand in the short-term when we need an economic boost. Second, the stimulus must not do further damage to our long-term fiscal situation. This goal is important not only for preventing needless harm to our future debt and deficit projections, but because the perception of long-term fiscal deterioration can hurt long-term economic confidence in a way that can negate some of the effectiveness of the stimulus package.

To date, I believe policy has been less than optimal in providing efficient stimulus.

A. Maximizing Efficiency of Stimulus? The Record So Far.

- **Poorly Targeted and Timed Consumer Demand Incentives**: If the goal of an economic stimulus is to pump more demand into the economy in a timely fashion, policy should aim to provide benefits to those most likely to put money quickly into the economy – those with a so-called high propensity to spend. Unfortunately, the Administration has failed to follow that basic principle in devising its stimulus policies. After failing to propose any direct stimulus in their initial 2001 tax cut package, the Administration did cede to calls for some form of rebate that would go into family's pockets in 2001. Their proposal was to advance a small portion of the tax cut so that families received $300 or $600 in the fall of 2001 instead of the spring of 2002. Yet, this advance was not refundable, so the 34 million low-income taxpayers with the highest propensity to spend the money did not receive a dime, and 17 million more received only a partial tax cut. As the Congressional Budget Office recently stated "As a general proposition, higher-income households save more of their income than do lower-income households... Consequently, tax cuts that are targeted toward lower-income households are likely to generate more stimulus dollar for dollar of revenue loss – that is, be more cost-effective and have more bang for the buck – than those concentrated among higher-income households."[3]

The Administration also missed the opportunity in both 2001 and 2002 to deliver a tax rebate before Christmas, when stores could have offered tempting deals, and consumers would have been most likely to spend the rebate, as some like myself called for.[4] On both occasions, no stimulus was passed before the Congressional Christmas recess.

Likewise, the Administration has been sparing in granting unemployment compensation, resisting Democratic attempts to extend benefits to the more than 1 million workers who have exhausted their benefits under the original extension.[5] This resistance comes even though unemployed families are not only among the most likely to spend the money, but are likely to do so in communities hardest hit by employment loss and subsequent falls in spending and demand. While poorly targeted unemployment compensation in a growing economy can stall job searches, with unemployment rising and the help wanted index at a 40-year low, this seemed to be a small risk. More targeting by the Administration and Congress toward helping with those with a higher propensity to spend may not only have helped some of our hardest pressed working families, it may also have helped the overall efficiency and effectiveness of recent stimulus efforts.

- **Poorly Designed Business Incentives:** Similarly, efforts to spark business spending have suffered from an inefficient approach to business incentives. A business stimulus should be clearly focused on encouraging businesses to accelerate investment into the period where there is a perceived weakness in economic demand. The rationale is that if business investment is weak, it can propagate weakness in the labor market and consumer confidence, leading to a downward cycle. While incentives to accelerate investment may simply be pushing up business investment that was planned for later years, the hope is that bringing some investment forward will forestall a downward cycle and quicken recovery.

The three-year 30% business depreciation bonus ignores this fundamental logic. Because the incentive lasts three years (and perhaps, since it expires on September 11, 2004 right before an election, creates the expectation that it will be extended further) CEOs who were holding back even planned business investment in 2002 were given virtually no incentive to accelerate their plans. Our depreciation bonus essentially said to them: if you're sitting on the fence on new business investment, we are indifferent whether you invest now or continue sitting on the fence until 2004! It is as if a clothing store put out a sale for this weekend only and then told buyers they were only kidding, that all products would also be on sale on various weekends for the next year. Why would anyone feel they had to buy now? In passing the three-year stimulus provision, the Administration and Congress ignored sound analysis from the Congressional Budget Office that stressed what academic evidence and common sense suggests: temporary business incentives will be far more effective than longer term or permanent ones. "[T]he stimulus provided by some tax cuts for business investment can be increased by making them temporary. Firms may view them as one-time opportunities for tax savings, which may induce them to move up some of their future investment plans to the present. They might not take that step if they knew that the tax advantage would remain in place…"[6]

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[3] Congressional Budget Office. *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, January 2002, p. 7.
[4] Sperling, Gene, "In Crisis, Stimulus and Discipline Go Together," *Bloomberg News*, September 21, 2001; Sperling, Gene, "Remarks at the Democratic Economic Forum," October 2002.
[5] Primus, Wendell, Jessica Goldberg, and Isaac Shapiro, "New Unemployment Insurance Extension Neglects One million Jobless Workers Who Have Run Out of Federal Unemployment Benefits," Center on Budget and Policy Priorities, January 14, 2003.
[6] Congressional Budget Office. *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, January 2002, p. ix.

Other business provisions included in the March 2002 stimulus bill, including those which extend rules allowing financial corporations to defer tax on some of the income from their subsidiaries abroad and temporarily increase the number of years back a business could carry a net operating loss to offset the earlier year's taxes, have been found by the CBO to be ineffective stimulus. Likewise, the House proposed but did not pass the elimination of the Corporate Alternative Minimum Tax, which was also deemed ineffective stimulus.[7]

- **Failure to Address the Consequences of State-Level Contraction:** Another failure of recent stimulus efforts is that they have ignored the basic economic reality that it makes little economic sense to use federal policy to stimulate $1 of demand only to support policies that will lead states to contract demand by a $1. For well over a year, Governors, state legislators, and many policy analysts including myself have called for significant assistance to states so that stimulative tax cuts and spending increases at the federal level are not partially or fully canceled out by tax increases or spending cuts at the state and local level. The National Governors Association (NGA) called for state relief as part of the initial stimulus plan as early as October 2001.[8] Considering the need for states to increase spending on homeland security, this policy imperative seemed especially straightforward. Yet, significant aid to states has been lacking.

  Again, our economy is paying the price for such sub-optimal stimulus policies. The Center on Budget and Policy Priorities projects that states are facing the worst budget crisis in 50 years -- an estimated deficit of $70-85 billion in FY 2004.[9] If the high end of this estimate pans out, states will be forced to cut on average $1 out of every $6 they spend. Across the nation the lack of federal assistance has already led to property tax increases, spending cuts – even letting people out of jail. Certainly these policy measures – along with the screaming headlines announcing them – are hurting demand and confidence.

  There is, of course, a "moral hazard" argument for not going overboard in making states whole. If states believe they can run through rainy day funds for popular policy measures with knowledge that the federal government will bail them out, this could promote irresponsible future policy. Yet, a one time injection of $30-$40 billion for homeland security, Medicaid and other vital needs would certainly help economically without coming near bailing states out of all of their difficult choices.

B. The Administration Seems Ready to Repeat the Same Mistakes.

In light of these policy shortcomings it is particularly disappointing that the Administration is proposing policies that seem to make these same mistakes all over again.

- **Inefficient and Ineffective Stimulus:** Of the $674 billion in their economic package in direct costs and over $900 billion including lost interest savings – only 15% would actually help the economy in 2003. Simply put, we are deciding to add more than 3/4 trillion dollars to our national debt for tax cuts whose effect will be felt in years when we are not explicitly seeking to provide a short-term economic stimulus. The worst offender is the repeal of dividend taxation at the individual level. While one could argue that altering the taxation of dividends could improve capital allocation efficiency as part of a comprehensive corporate reform that also closed loopholes leading to "zero" taxation and was deficit neutral, the provision is widely acknowledged as a very poor stimulus. Indeed, when one considers both the program's uncertain benefits and its long-term cost, this proposal cannot be economically justified at this time.

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[7] Congressional Budget Office. *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, January 2002.
[8] "Governors Propose Package To Strengthen State-Federal Safety Net," National Governors Association News Release, October 4, 2001.
[9] Lav, Iris, and Nicolas Johnson, "State Budget Deficits for Fiscal Year 2004 are Huge and Growing," Center on Budget and Policy Priorities, January 23, 2003.

Other provisions also fail the efficiency test. While increasing the tax cuts for middle-income taxpayers and the child tax credit in 2003 can be justified on stimulus grounds, the complete acceleration of 2006 cuts increases deficits in the years 2004 and 2005, when we may wish to be more focused on increasing national savings than on further stimulus.

- **Inefficient Business Incentives:** Other than the dividend exclusion, the only business incentive in the Administration's proposal – the increase in Section 179 to $75,000 – is permanent, meaning that it is unlikely to provide an incentive for any short-term acceleration of business investment.

- **Poorly Targeted to Consumers with High Propensity to Spend:** While as mentioned above, some of the Administration's tax cuts should be considered if they were limited to 2003, the Administration again leaves out lower income taxpayers who would have the highest propensity to spend. While taxpayers earning over $1 million would average nearly $90,222 in tax cuts in 2003, close to half of tax filers would receive $100 or less.[10]

- **No Help To States:** Despite now overwhelming evidence that states are forced to counter federal stimulus efforts with contractionary tax increases and spending cuts, the Administration's proposal not only fails to give states any assistance, but the proposal would deepen their short-term hole by $4 billion.

C. Recommended Policies

1. **No Long-term Deficit Costs Outside of 2003:** The fundamental rule for the efficiency of stimulus and the test for ensuring long-term fiscal strength is that all increases in the deficit are limited to efforts to directly stimulate the economy in 2003. Therefore, all consumer tax cuts and business incentives should be limited to the current calendar, if not fiscal, year.

2. **Temporary Increase Business Incentive:** Since October 2001, I have proposed a staggered depreciation bonus which would give serious short-term incentives to accelerate new business investment.[11] Originally I proposed a 40% bonus that would fall to 20% in less than a year to encourage businesses to act quickly. Now that the 3-year 30% depreciation bonus has been passed, I believe it would be best to increase the amount of depreciation in 2003 to 45-50%, and have it fall to 20% in 2004. It would also be sensible to increase the 179 expansion limit for small businesses, but only in 2003. These changes may not make a significant difference for telecom and other companies with substantial excess capacity, but for the significant number of companies who are simply postponing investment out of uncertainty, such temporary measures will provide an incentive to accelerate investment into 2003 without significantly affecting expectations created by last year's tax changes.

3. **Target One-Time Assistance to Those Most Likely To Spend:** For some time, I have proposed a refundable tax cut on payroll taxes to provide targeted short-term stimulus. There are various ways in which this could be done, but the key is to get the funds out quickly to those with highest propensity to spend, and to avoid out-year deficit costs.

4. **Unemployment Extension:** By the same rationale, unemployment benefits should not only be extended but also expanded to the more than one million workers who already exhausted their benefits under the original extension and who are among the most likely to spend new resources.

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[10] Orszag, Peter and William Gale, "The President's Tax Proposal: Second Thoughts," *Tax Notes*, January 27, 2003, p. 605.

[11] Sperling, Gene, "Business Incentives Must Get Small Stuff Right," *Bloomberg News*, October 18, 2001.

D. Framework for a Potential Compromise

1. **Agree quickly on a mix of Administration and Democratic Stimulus measures with no out-year deficit costs:** Several of the Administration proposals – doubling the child tax credit, increasing Section 179 expensing to $75,000 – could be merged with Democratic proposals for a one year increase in the depreciation bonus, expanded unemployment insurance and refundable family tax credits. The test would be both efficiency and a lack of out year deficit costs;

2. **Consider policies with long-term deficit projections at a later time in the year as part of overall budget process.** Policies with long-term deficit costs – from tax cuts to expanded prescription drugs – could be debated within a long-term budget framework in which the overall long-term costs of all proposed policies could be examined as well as potential measures for long-term savings. This would not force anyone to "give up" on their proposals, but would serve two purposes: one, it would ensure that long-term fiscal policy is being considered in a rational, comprehensive manner, in which the long-term trade-offs are transparent; two, it would prevent controversial long-term measures such as the exclusion of dividend taxation for individuals from stalling a stimulus plan from passing when it is most needed and while it can still be most effective.

III. Policies to Lay Foundation for Long-term Growth

As mentioned at the outset, the most important task for policymakers is to promote policies that strengthen the long-term fundamentals of our economy. Such policies must aim to promote a strong long-term investment climate; protect our economy's dynamism and spirit of innovation, promote competition and productivity, and ensure that all of our people have a chance to both contribute to and benefit from our growth and wealth creation process. Such fundamentals are to my mind best promoted when we show commitment to long-term fiscal responsibility to promote savings and long-term confidence; promote open markets that spur exports, provide low prices for our families, inject competition into our economy; and target our federal resources to improving the skills and productivity of our people, rewarding work, providing opportunities for wealth creation for those most hard-pressed, and promoting the basic research that not only saves lives, but as Bill Gates Sr. recently said, provides a gift to future entrepreneurs.

Today, I will focus on one of those fundamentals: the importance of long-term fiscal responsibility. The recent effort by the current Administration to downplay the benefits of fiscal discipline are hard to understand based both on economic fundamentals and on recent economic history.

If I were giving this testimony a few years ago, I would focus mostly on what I believed were the best measures to achieve fiscal discipline and would not have felt compelled to make the case for why fiscal discipline matters. Indeed, during the mid 1990s, the debate centered on the best path to achieve fiscal discipline, rather than whether or not the policy mattered at all. Yet, while this Administration calls for restraint of non-defense and non-homeland security spending, it has challenged the very significance of long-term deficit and surplus projections to our economic health. For that reason, I would first like to address three misconceptions promoted by the Administration before turning to the positive case for continued fiscal discipline.

Misconception One: Since Short-Term Deficits are Justifiable, So Too Are Long-Term Deficits.

Basic Keynesian economic theory dictates that, in a slow economy, it makes sense to use temporary tax cuts or spending increases to boost spending. So when policymakers say we should not worry about a temporary rise in the deficit in a time of economic weakness or war they are right. But the crucial words are "temporary" and "time of economic weakness or war". Unfortunately too many commentators misrepresent this Keynesian logic to suggest that it would be wrong to worry about current policies that may be imposing trillions in long-term costs. The need for a temporary rising deficit to boost demand and prevent a downward cycle does not in any way diminish the importance of long-term fiscal discipline. Likewise, when one is injecting fiscal demand in a period of economic weakness, there is nothing illogical or Hoover-like in being concerned with the long-term fiscal discipline.

Misconception Two: Deficits Do Not Affect Interest Rates

The Administration's virtual campaign to downplay the economic significance of raising long-term deficits is a sharp turn from the bipartisan mainstream consensus that existed even just a few years ago. Consider the sharp divergence of recent statements of the current Chairman of the Council of Economic Advisors with the previous statements of his predecessors under the past two Republican administrations:

- **Reagan Council of Economic Advisers under Chairman Martin Feldstein:** "Measures to reduce the budget deficit would lower real interest rates and thus allow the investment sector to share more fully in the recovery that is now taking place primarily in the government and consumer sectors."[12]

- **Bush I Council of Economic Advisers under Chairman Michael Boskin:** "Economic theory and empirical evidence indicate that expectations of deficit reduction in future years, if the deficit reduction commitment is credible, can lower interest rates as financial market participants observe that the government will be lowering its future demand in the credit market... In other words, expectations of lower interest rates in the future will lower long-term interest rates today. Lower long-term interest rates will reduce the cost of capital, stimulating investment and economic growth relative to what would be predicted if expectations were ignored."[13]

- **Bush II Council of Economic Advisors:**
  - "As an economist, I don't buy that there's a link between swings in the budget deficit of the size we see in the United States and interest rates...There's just no evidence."[14]
  - "I hope that the discussion will move away from the current fixation with linking budget deficits with interest rates. This linkage does not make a great deal of sense in a world in which global capital markets move trillions of dollars, and federal borrowing is only one – and far from the primary – use of funds. Not surprisingly, the evidence is that long-term interest rates do not move in lockstep with actual or expected federal budget changes."[15]
  - "We have very little empirical evidence to suggest much of a link between deficits and interest rates."[16]

The surprising campaign against the significance of deficits has been presented as reflective of academic literature that according to such advocates is uncertain at best as to the link between deficits and interest rates. This position is simply unfounded. First, as Brookings economists Peter Orszag and Bill Gale have correctly noted, the right question is not how current deficits affect current interest rates, but rather how the *expectations of future deficits* affect current rates. One might perhaps find that a belly-up company's stock price is not dramatically affected on the day it technically goes into court to file for bankruptcy. Yet no one would suggest that the expectation that a once-healthy company is going bankrupt does not dramatically affect stock prices. Likewise, when one focuses on the expectations of deficit changes, one not surprisingly finds a clear link between deficits and interest rates. For example, a new paper by three Georgetown economists presented at the 2002 Federal Reserve Conference in Jackson Hole,

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[12] Economic Report of the President, February 1984, page 62.
[13] Economic Report of the President, February 1991, page 64.
[14] Glenn Hubbard quoted in Stevenson, Richard, "Bush's Way is Clear to Press His Agenda for the Economy," *New York Times*, November 11, 2002.
[15] Remarks by Glenn Hubbard at *Tax Notes* 30th Anniversary, December 10, 2002.
[16] Glenn Hubbard quoted in Stevenson, Richard, "On Tax Cuts and Deficits, a Battle of Believers," *New York Times*, February 10, 2002.

Wyoming found that an increase in CBO deficit projections of 2% of GDP increased long-term interest rates by over one percentage point.[17]

Indeed, a recent comprehensive review of the deficit-interest rate literature by Brookings Economists Peter Orszag and William Gale found that 16 of the 17 academic studies that looked at the effect of expected deficits on interest rates found a clear and significant link. Furthermore, most of the world's top fiscal and economic experts, including Harvard's Martin Feldstein, current Treasury Undersecretary John Taylor, Federal Reserve Chairman Alan Greenspan, and his predecessor Paul Volker have all explicitly written that deficits do indeed affect interest rates, and this fundamental relationship is built into the economic models used for decades under both Democratic and Republican Administrations at the Federal Reserve, the Congressional Budget Office and the Office of Management and Budget.[18]

Let me also say a word about recent statements suggesting that the current low nominal interest rates provide proof that deficits do not matter. This assertion ignores the demand side of the law of supply and demand. The fact that nominal rates are low in the current period of economic weakness when demand for capital is low is not surprising. What is important is whether they would have actually been lower absent the fiscal deterioration, and indeed there is evidence to suggest that long-term interest rates might have followed short-term rates even further down during substantial periods of the past two years, had the long-term deficit not been rising.

Misconception Three: The Effect of the Administration's Policies on Long-Term Deficit Are Moderate.

When the current Administration has been challenged on the notion that deficits do not matter, they have at times sought to modify their view by suggesting that the impact of their tax cuts are "moderate" and that such "moderate" changes in our fiscal picture have no significant economic impact. Yet there is nothing moderate about the recent swing in our fiscal position or the negative long-term impact of the administration's tax cut proposals. The CBO projected in January 2001 a ten-year surplus of $5.6 trillion, and now many experts are projecting a deficit of $1-2 trillion over the coming decade.[19] To paraphrase a former Member of Congress, $7 trillion here and there is still real money. Furthermore, when one adds up the cumulative impact of the Administration's tax policies, the negative impact would be more than $4 trillion over the coming decade (see table below).

Cumulative Cost of the Administration's Tax Cuts

	Revenue Loss	Debt Service
New Administration "stimulus" proposal*	670	250
Remove sunset on 2001 tax legislation*	615	50
AMT reform (estimate)*	550	100
2001 Tax Cut (EGTRRA)**	1350	553
Totals	**3185**	**953**
Grand Total	**4138**	

Note: All figures are for the period 2003-2013, except the EGTRRA, which is from 2001-2013 including interest costs.
* Estimates from Friedman, Joel and Richard Kogan, "Full Cost Of Administration's Agenda For New Tax Cuts Is At Least $2.2 Trillion Through 2013" Center on Budget and Policy Priorities, January 25, 2003.
** Estimates based on "Why the Surplus Has Disappeared" Center on Budget and Policy Priorities, September 3, 2002.

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[17] Canzoneri, Matthew B., Robert E. Cumby, and Behzad T. Diba, "Should the European Central Bank and the Federal Reserve Be Concerned About Fiscal Policy?" *Paper Presented at the Federal Reserve Bank of Kansas City Annual Conference,* August 2002.
[18] Gale, William and Peter Orszag, "The Economic Effects of Long-Term Fiscal Discipline," *Urban-Brookings Tax Policy Center Discussion Paper*, December 17, 2002.
[19] Congressional Budget Office, *Economic and Budget Outlook: 2002-2012*, January 2001.

IV. The Case for Continued Fiscal Discipline

Having set the record straight, it is fundamentally important for us to understand the importance of fiscal responsibility to the long-term performance of our economy. Below I outline seven ways in which fiscal discipline contributes to the type of sustained, shared economic growth we experienced in the 1990s.

1. Fiscal discipline increases national saving

The main contribution to our net national savings rate in the 1990s was an improvement in our fiscal position. Despite a declining rate of personal savings, The U.S. was able to nearly double net national savings over the course of the 1990s, from 3.4% in 1993 to 5.9% in 2000. This was accomplished by moving the federal government from a policy of dissavings and deficits of 4.1% of GDP to a policy of savings and surpluses of 2.1% of GDP -- a swing of 6.2% of GDP. By the end of the decade, the government was "crowding in" private sector capital by paying down debt and adding to the pool of capital available to finance productive investments. The increase in national savings during this period laid a foundation for the longest economic expansion in modern history.

2. Fiscal responsibility promotes a strong long-term investment climate through low interest rates and increased confidence

As described above, there is overwhelming evidence that fiscal discipline helps keep long-term interest rates down by increasing the pool of savings available to make investments, thus improving the long-term investment climate. Deficits, on the other hand, can crowd out future private investment. As Harvard's Martin Feldstein explains, "[A]n anticipated future budget deficit means a smaller amount of funds at that future date to finance investment in plant and equipment. Restricting that investment will require a higher real rate of interest. Similarly, the anticipated budget deficit means that individuals will have to be offered a higher yield in the future to induce them to hold the larger amount of government debt in their portfolios. Both of these effects raise the expected future interest rate and therefore...they raise the current long-term rate as well."[20]

Fiscal discipline also improves the investment climate by generating confidence in the U.S. economy. It was the opinion of all of the Secretaries of the Treasury in the Clinton Administration that fiscal discipline was an important component of the image of strength and stability that the U.S. economy projected to the rest of the world. That image led foreign investors to demand a smaller risk premium for investments in the U.S.

As Federal Reserve Chairman Alan Greenspan explains "returning to a fiscal climate of continuous large deficits would risk returning to an era of high interest rates, low levels of investment, and slower growth of productivity...history suggests that an abandonment of fiscal discipline will eventually push up interest rates, crowd out capital spending, lower productivity growth, and force harder choices upon us in the future."[21]

3. Fiscal discipline translates into real savings for the American family

The impact of fiscal discipline goes well beyond businesses and large investors, and has important implications for the average American family. For example, a middle-line estimate based on the Federal Reserve, Congressional Budget Office and other mainstream macroeconomic models suggests that the cumulative size of the Administration's proposed tax cuts -- measured by their projected impact on the ten-year deficit as a share of GDP -- would raise long-term interest rates by more than 200 basis points. This would not only seriously discourage new business investment and reduce the value of the stock market, it would also mean a $3000 increase in annual mortgage payments for a family holding a 30-year $200,000

[20] Martin Feldstein, "Budget Deficits, Tax Rules, and Real Interest Rates," *NBER Working Paper No. 1970*, July 1986, page 13.

[21] Greenspan, Alan, "Current Fiscal Issues" Testimony Before the Committee on the Budget, U.S. House of Representatives, September 12, 2002.

mortgage.[22] That is more than the typical family would receive from the Administration's tax cut proposals over the long-term.

4. Fiscal responsibility promotes a virtuous cycle of economic growth

Some have suggested a simplistic dichotomy in the debate over fiscal policy -- either surpluses create growth or growth creates surpluses. Clearly the overall goal of fiscal policy is to encourage growth, not fiscal discipline for its own sake. But real question is: what fiscal policies lead to sustainable growth by helping to expand our economy's capacity, rather than running it up against an inflationary wall? A key lesson of 1990s was that fiscal discipline was critical to creating a virtuous cycle. By creating a larger pool of savings, fiscal discipline kept interest rates low for new investment, and because surpluses were being saved, additional capital was being provided just when investment demand was rising. The effect? According to a Goldman Sachs analysis in April 2000, "the swing in federal budget position from a deficit of $290 billion in 1992 to a surplus of $124 billion in 1999 - roughly matching the improvement in the general government position - has lowered equilibrium bond yields by a full 200 basis points."[23] This spurred productive investment that expanded capacity, and as growth and productivity picked up, we grew at rates not seen in decades as inflation stayed low. A substantial amount of this productivity growth appears to be lasting: productivity averaged only 1.4% annual growth from 1973 to 1995, but has averaged 2.25% from 1995 to 2001.

This virtuous cycle allowed for the longest productivity expansion in history, which has been sustained even at the end of the period of economic growth. While some of the investment in the end of the 1990s turned out to represent excessive optimism and herd investing, we should not underestimate the enormous benefits of such a long and sustainable expansion. The unemployment rate fell to its lowest levels since 1969. Wage growth, which had been stagnant for decades, recommenced. In 2000, the share of the population living in poverty fell to its lowest rate since 1974.

To be sure, fiscal discipline is not a silver bullet; other factors contributed to the positive economic developments of the 1990s. However, fiscal discipline was a critical element in fostering the environment that allowed the growth of the 1990s to be strong and sustained. As Chairman Greenspan has stated, "[t]he lower federal deficits and, for a time, the realization of surpluses contributed significantly to improved national saving and thereby put downward pressure on real interest rates. This, in turn, enhanced the incentives of businesses to invest in productive plant and equipment."[24]

5. Fiscal discipline is the key element in generational responsibility

For years in the late 1990s there was bipartisan and widespread support for the idea that we should save surpluses to meet the baby-boom retirement challenge without passing on the burden to the next generation. A key component of this generational responsibility is to adopt policies that increase savings to spur long-term productivity so that a smaller number of workers can support the larger number of future retirees without oppressive tax increases or spending cuts. Another imperative is to make sure that there are funds available to finance the transition costs required to make most Social Security reform plans more viable.

Nothing has happened in the last two years to suggest that Social Security and Medicare require less national savings and less generational responsibility. Yet we no longer have the bipartisan commitment. Instead of saving for the next generation, we have passed large, consumption oriented tax cuts that will increase the burden on our children and grandchildren. Over time, the loss in revenues

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[22] Estimate based on Gale, William and Peter Orszag, "The Economic Effects of Long-Term Fiscal Discipline," *Urban-Brookings Tax Policy Center Discussion Paper*, December 17, 2002.
[23] Goldman Sachs, GSWIRE Undistorted by the Budget Surplus, April 14, 2000.
[24] Greenspan, Alan, "Federal Reserve Board's semiannual monetary policy report to the Congress" *Testimony Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*, July 16, 2002.

associated with the Bush Administration's tax cut proposals is two- to three-times the amount needed to cover the 75-year shortfall in Social Security.[25]

6. Fiscal responsibility prepares us to deal strongly with economic downturns

As I have explained, it makes eminent sense to run deficits during a recession in order to jumpstart the economy. But this cannot be seen as an excuse to abandon long-term fiscal discipline. It is important to realize that policies of long-term responsibility are themselves critical to giving us the flexibility to run temporary deficits for stimulus or national security reasons without significant negative consequences. Because of previous commitments to save surpluses, the recent dramatic shortfall in revenue and use of fiscal stimulus left us with a deficit in 2003 of only 1.5% of GDP -- as opposed to a projected surplus of $300 billion, or 3% of GDP. Had we gone into this period with policies that tolerated even relatively small deficits, this swing could have driven deficits this year to $500-600 billion, or 5-6% of GDP, which would have been among the biggest since WWII. Simply put, long-term fiscal discipline gives us the flexibility to unload both our fiscal and military cannons without driving us into a precarious fiscal situation.

7. Fiscal responsibility helps us meet new and old challenges

Clearly, fiscal discipline must always be balanced with the need to address our nation's new and lingering challenges. Yet if we are to be able to meet new spending challenges in homeland security as well as lingering problems of child poverty, educational inequity, and AIDS both here and in the world's poorest countries, we must choose wisely, so that we do so in the overall context of long-term fiscal discipline.

V. Policy Implications: We Need a Pro-Growth Grand Bargain

What is needed is a pro-growth grand bargain that addresses both the short-term and the long-term. On the long-term side, there is no question that a commitment to fiscal discipline will require mutual sacrifice. President Bush needs to begin the politically difficult process of bringing all parties together to work out a bipartisan compromise. A pro-growth grand bargain will not require raising taxes but it will require the President being willing to put his own priorities on the table to give him the moral standing to ask others to do so as well.

My personal proposal for such a grand bargain would go as follows: The President and Congress would start by agreeing to a $100-$150 billion stimulus that would draw on ideas from both parties – as long as they had a high bang for the buck and did not have out year deficit costs. Next, the President would guarantee that while Americans would continue to get tax relief, new rounds of tax cuts that only affect those making over $150,000 would be frozen. As I have described elsewhere,[26] this savings alone would be enough to close 53% of Social Security's 75-year insolvency gap. Congress, on the other hand, would agree to hold back on excessive new entitlement costs – including for prescription drugs. Such a pro-growth grand bargain would show our citizens as well as world investors that even as we continue to defend our homeland and strive for greater hope and opportunity, the era of fiscal responsibility is not over in the United States.

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[25] Orszag, Peter, "The Administration's Economic "Stimulus" Proposals," *Testimony Before the Democratic Policy Committee,* January 22, 2003.
[26] Sperling, Gene "Fiscal Chutzpah," *Washington Post,* July 31, 2001.

Chairman NICKLES. Mr. Sperling, thank you very much, and to all three of our panelists, thank you, and I appreciate your respect for the Committee's time. We have several members that wish to ask a few questions, and I think all of you will have a chance to add additional comments during the question and answer session.

I might want to mention, I should have mentioned it before Mr. Baroody made his speech or comments. One of the reasons why I requested—I still wear a manufacturer's hat on occasion. I came from the private sector. I look at the economy as a great engine that is able to overcome and has overcome a lot of obstacles in the past. There are a lot of things that can impede economic growth. I used to hire a lot of people in the private sector. Excessive taxation can impede your ability or willingness to grow, but also can excessive regulation and also excessive litigation. One of the reasons why I requested Mr. Baroody is because I am very concerned, maybe even—you know, we are going to have a significant discussion and debate in this committee, in the Finance Committee, and on the floor of the Senate about what the size, scope, duration of the growth package should be. How much of it should be up front? Very legitimate question. Those are all good questions. Good, frank discussion. Then how do we put it together?

I think the President has a very good package. If I was drafting it, I probably would have put something a little different. Being a manufacturer, I like expensing. I want to recoup that investment as rapidly as possible. I would like to depreciate things in the year that you write the check or shorten the depreciation cycle as much as possible. Or maybe if you are going to do—and, Mr. Malpass, you don't need to get me—I have a list. My staff has done my work. I have the list, and the United States is the second highest to Japan on taxing corporate dividends, second highest in the world, if you add corporate tax and the tax on consumers, the effective rate of 70 percent, only Japan is higher. Now, that is not good, not if you want to encourage investment and have earnings distributed to owners. It is just bad tax policy.

There are different ways of fixing that. One way of fixing it would be to allow the corporation to deduct the dividends. That would be my preference. It is probably more expensive. Those are things that are probably more efficient. So those are things that we will have to weigh not only in this committee but also in the Finance Committee.

One of the things I wanted to do, I want this committee to think broad. When we are talking about growing the economy, it is not just how we make a few little changes in tax policy, but also are there some things on the regulatory side or the litigation front? I am very concerned from a manufacturing standpoint they are probably more concerned about asbestos' potential liability than they are tax cuts or taxation of dividends, probably much more concerned, because one can be a fatal blow.

Mr. Baroody, I think you mentioned that there were 60,000 jobs lost and a potential to lose another 300,000 or 400,000. Is that correct?

Mr. BAROODY. That is correct, sir.

Chairman NICKLES. Well, that is staggering, because we are talking about jobs. You are talking about in most cases, I would think, jobs that pay pretty well. I am concerned about the loss of manufacturing jobs in this country. We have had growth in a lot of sectors. Manufacturing is not one of them. So I mention that.

I am going to ask all of our colleagues, myself included, to adhere to a 5-minute time limit if they would so we can make sure that colleagues don't have to wait too long, and we will do it by order of appearance. First I will call on my colleague Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman, and thanks for the comments. Thanks to this panel of witnesses. I thought they were excellent and very interesting.

Mr. Malpass, in your testimony that appears on page 11, there appears to me to be a contradiction, and maybe you can help me understand why you don't see it that way. You say there, "I expect long-term U.S. interest rates to rise during 2003, but not because of increased government borrowing. Rather, the private demand for credit should rise as the expansion gains traction, putting upward pressure on interest rates."

It would seem to me that you are saying increased demand for private credit puts upward pressure on interest rates. Why not increased demand from the governmental sector for credit? Why doesn't that put upward pressure on interest rates as well?

Mr. MALPASS. Part of that is the magnitude. The total debt in the U.S. is $20.4 trillion of which the Government portion is only $3.7 trillion. So as private demand goes up for credit, that is simply a bigger chunk.

Another way to look at this is U.S. Government debt versus the $8.3 trillion issued by the other six major issuers of Government debt. Even though we do have a big national debt, it is small relative to what other countries are issuing.

The U.S. is at a debt-to-GDP ratio of 34 percent now. The contemplated fiscal deficits, are simply not large compared to the other demands. There is a statistic——

Senator CONRAD. Let me ask you——

Mr. MALPASS. Yes?

Senator CONRAD. Let me ask you, if I could, I understand the point that you are making, but it would seem to me that you are making the point that increased demand for private credit puts upward pressure on interest rates even though the governmental sector is smaller in terms of outstanding debt. Nonetheless, an increasing demand from the public sector would also have the effect of putting upward pressure on interest rates, would it not?

Mr. MALPASS. Actually, no, sir, and I am not sure if I gave a complete answer before. There is a concept in economics called real interest rates or the real return on capital. Excluding inflation, it is the return on capital hurdle that you have to meet. As the economy begins to grow, then people want to put their money in faster-growing investments. That raises the real interest rate within the economy. As the private sector begins to gain traction, what you are going to see is real interest rates going up, meaning people have other alternatives for where they can put their funds. That is simply not the same effect as what you would get from a fiscal deficit.

Senator CONRAD. Mr. Sperling, maybe I could turn to you. I must say that logic eludes me. It seems to me that to whatever extent either the private sector is going and increasing its demand for credit or the governmental sector increases its demand for credit, both of those put upward pressure on interest rates. Mr. Sperling, I would ask your evaluation of that question.

Mr. SPERLING. Senator, I guess I would share more your perspective. Nothing about capital repeals either the law of supply and demand or the law of fungibility. The question is—and I think this is the right way to think about it—that when the private sector goes into our capital savings, when the private sector looks for capital to borrow, to invest for productive growth, is there a greater supply of capital available to them because the Government is paying down debt, or is there less capital available to them because the Government is crowding out?

If the Government is essentially borrowing, we are reducing the supply of capital for a given amount of demand. Basic economics would suggest that in that situation the cost of capital, which is measured in terms of interest rates, would go up. There is nothing to suggest otherwise.

One of the things that I try to say in my testimony is that this perception, this argument that the amount of deficits increase interest rates is not one I learned on the Democratic side. I learned it from listening to Republican CEOs in the 1980's. That is where I learned the phrase "crowding out." What I list in my testimony is the past language of Michael Boskin, of Martin Feldstein. So that really supports this basic supply and demand.

There is even another element, which is, to the degree that you fear that there will be increased deficits in the future, you have a degree of uncertainty that would make a borrower ask for a greater risk premium and could also raise deficits higher. So, you know, I think that the sentence that you referred to there is exactly the point, which is that as the private sector asks for more funds, as the economy strengthens, interest rates will go up because there will be less capital. I do point you to an analysis from Goldman Sachs on April 14, 2000, that I mentioned here, where they suggest that the swing in the deficit during that period of growth kept interest rates 200 basis points lower. So according to Goldman Sachs, because the Federal Government, as opposed to borrowing $200 billion, was paying down $200 billion in debt, that $400 billion swing was responsible for up to 200 basis in lower long-term interest rates, and that is the type of—therefore, leads to the type of sustainable long-term investment climate that I think we all would like to promote.

Senator CONRAD. My time has expired.

Chairman NICKLES. Senator Conrad, thank you very much.

Next I will call upon Mr. Enzi. I am going to step out for a moment, but after Senator Enzi is finished, I believe Senator Corzine would be next. Senator Enzi, if you would please chair in my absence, I would appreciate it.

Senator ENZI. Thank you, Mr. Chairman. I want to express my appreciation for having the opportunity to serve on this Budget Committee. As a long-time accountant and small businessman, this is really the first opportunity I have had in the Senate to deal with numbers. I find it very exciting. I understand the critical role the budget plays in today's economy, and I welcome the challenge of creating a budget that is fiscally responsible.

I note this committee has a tremendous amount of power. It develops the foundation for the work of the Senate, and I appreciate your being the Chairman. Further, I appreciate the conversations and meetings we have already had and I believe we are moving in the right direction.

Chairman NICKLES. Well, we welcome you to the Committee.

Senator ENZI. Thank you. I earned an accounting degree at George Washington University here in the District, and as a result, there was a tremendous immersion in governmental accounting. Given that knowledge and valuable experience I have to say that, while we are tromping on corporations for bad accounting, we really ought to be embarrassed about the Government. This isn't working at all like the textbooks. [Laughter.]

Senator ENZI. Of course, I am not saying the textbooks were flawless either. I think there is a lot of room for improvement.

I had the opportunity over New Year's to go down to Brazil to witness the inauguration of the new President. To meet with him and several members of his cabinet. I was shocked to find out they consider their government a leftist government. They don't define politics as conservative or liberal, that sort of thing down there. Of course, when I had an opportunity to ask the President what the main goals of their government is, he said the number-one goal was balancing the budget. The number-two goal was to try and get government to the lowest level possible, to that closest to the people. Finally, the third was to reduce bureaucracy. That sounds pretty conservative to me.

They have a whole different understanding, a more comprehensive understanding than we do of the importance of balancing a budget down there. They can see how it affects their economy, and we ought to be able to see that, too.

When I came 6 years ago, we talked about balancing the budget, and we did a balanced budget constitutional amendment debate. We didn't pass that, but the American people held our feet to the fire and said balance the budget. We got the message, even though we didn't get the constitutional amendment. We balanced the budget and we did that for quite a while.

However, in recent years, we have started spending more. I think the worst word in the American dictionary is probably "surplus," surplus when you have a huge debt. Apparently, surplus means you can spend a lot. We did began spending. We avoided that balanced budget, and the economy went down. I do think there is a relationship there.

Now, to get to my questions, Mr. Baroody, you mentioned a lot about asbestos. What are you suggesting as a solution to the asbestos problem?

Mr. BAROODY. Senator Enzi, the Asbestos Alliance, which the NAM leads and is comprised of now more than 150 organizations, most of them companies but some other associations, has for some time been urging on the Congress consideration of legislation that in its essence would establish in law medical criteria that would encourage if not require that the courts make the vital distinction they are not now making, namely, between people who are sick and deserving of compensation and people who are not sick.

The corollary to that would be to take the latter group, the people who are not currently sick, even if they can propose evidence of exposure to asbestos, which a lot of us can do, and suggest that the statute of limitations be tolled, so that if they should subsequently become sick, they haven't forfeited by artificial deadline in the law the opportunity to seek compensation subsequently.

There are other aspects to the legislative ideas we have urged on the Congress, but the essence is that medical criteria approach.

Senator ENZI. Thank you.

For each of you, again, referring back to my comment about a balanced budget and the inability of Government to spend a country into wealth, a proposal that keeps coming up is for giving $150 or $300 to everybody in the country. Isn't that a rather small level even for those at or below the poverty wage? So how much of an impact will that have? Is that the best way for us to go? Let's start with Mr. Malpass.

Mr. MALPASS. For a lot of people, $100 or $300 is significant, and so I don't want to dismiss that as a generosity by the Federal Government. I guess the issue is whether you create more jobs and long-term growth by having the Government take money from the people and then give it back to certain people. That is a redistribution of income. You tax from one group and then you give back. In fact, we have huge transfer programs which have that effect. It is part of the progressivity of our system.

One of the debates that is going on right now is simply what will be the first quarter or the second quarter growth rate if we gave $300 to everybody in the country. I think that we just wouldn't see that much impact because a lot of the people that get that money would figure out that in the end the Government was going to get it back from them. So they might spend a little of it and save some other part of it, and we wouldn't have accomplished anything in terms of changing the growth incentives for companies to be created, to hire workers and make long-term growth.

Senator ENZI. Mr. Sperling?

Mr. SPERLING. Thank you, Senator. As to your direct question, I think that the idea is and the relation to growth is that if you get too many companies sitting on the fence, essentially they are looking out and not seeing many people spend. Then it is understandable that they don't want to invest or hire more people now. The more they do that, the weaker consumer confidence gets, the less people spend, and you get a more negative cycle. So that is why I think as an insurance policy injecting money into people who are likely to go to the store, spend it, so that it might at least convince some companies to not do further layoffs and hopefully get people expanding again makes sense.

In terms of the question of the impact and the balanced budget, this is how I would look at it. When you are trying to stimulate the economy, I think you could make a good case for doing more, Senator, than that amount. So, for example, I think one could go higher in your tax cut for families to help stimulate the economy now. I would not make—but I think when you extend that, then you have to deal with the benefits of that versus the negative costs that you mention of moving away from balancing the budget, because tax cuts or spending will both likely have a negative impact on the long term, which is why, if I could be bold enough to say where I would be, I think a good compromise for this Congress would be to take some of President Bush's ideas to give people closer to—families closer to $1,000 this year to help inject more spending into the economy right now when we need it, but just make it a 1-year plan. Let's get that done quickly when we need it now. Then we all have these major debates on dividends, long-term tax cuts. Some of us would like to freeze some of those things. Let's have that debate later. Let's not have those debates about the long term hold us from injecting something into the economy right now that could help stimulate demand and make sure we don't fall into a negative cycle.

Senator ENZI. Again, I have to apologize to Mr. Baroody, but I have used up my time.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Enzi. I truly appreciate this discussion. I think this is the heart of the issues that need to be debated with regard to how our Government interfaces on economic policy. I am a big believer that national savings actually ends up driving investment and we ought to do those things that improve that. I come down on the side of thinking managing our Federal deficit over a cycle toward balance is the best way to improve particularly private sector investment, and we need to address that. I appreciate the discussion we had about the interaction of particularly Mr. Sperling's interaction of growth and our economic situation, the Federal and State budgets. I think to talk about $90 billion worth of deficits at the State level and talking about growth programs or stimulus programs that ignore that I think are very weak.

What I would—since the heart of the proposal on the table for growth—I guess we are not using the word "stimulus"—is the dividend exclusion. I would like to poke around a little bit on that.

Am I not correct, David, or any of the witnesses, isn't valuation of most companies driven by net free cash-flow? Isn't that the basic theory of how we get to——

Mr. MALPASS. I will go along with that.

Senator CORZINE. I would like to understand how it is that when we take cash off the balance sheet of corporate America at a period in time when we are not seeing strong investment, that we think that is somehow or another is going to encourage growth or stimulus. One might argue, no matter how you felt about double taxation on dividends, that potentially you would want to have the dividend potentially deducted at the corporate level to deal with the interest issue, but you wouldn't want to take cash off a balance sheet if you are trying to grow companies. When you go to a bank, you have to put down a margin. When you hire people, you have to pay them. You have to have cash to be able to do that. It seems to me that when we see these economic models show a slow to limited growth even by the President's projections, I think what we are actually seeing is a robbing of cash off the balance sheets of companies. This is a pretty dangerous thing to do in a period of slack growth.

Mr. MALPASS. I don't think I agree with that way of thinking about it. Let me see if I can state my view on it.

Right now, if a company has retained earnings or, over its life, is going to earn money and create retained earnings, there is a wedge between that company and the shareholders. There is a toll gate. If you want to give the cash to the owners of the company, you have to pay a hefty tax to the Government.

That blocks the turnover of capital within the economy, so you have a lot of companies that really don't need the cash. The logical thing for them to do is give the cash to the shareholders who can then reinvest it somewhere more effectively. That can be achieved by lowering the toll on the capital.

As far as free cash-flow, if you lower the double taxation of corporate earnings, which I think is an onerous burden right now, you get a lower cost of capital and a better distribution of capital within the economy. You get companies that don't need the cash giving up some of their cash to companies that can have a higher return on investment from that new cash.

Senator CORZINE. How does that connection work? I mean, is there any kind of certainty that the cash that Microsoft gives up on its balance sheet is going to go to someone that is going to have a higher rate of return on capital in that? Why is that stimulus or growth in any kind of short-term period of time? Isn't it really the judgment about what the internal rate of return would be available on various investments that that company has?

Mr. MALPASS. As we think about the late 1990's, I think one of the things that happened was a bubbling in Nasdaq. Part of that was because companies had every incentive to keep all the cash and go make acquisitions, even at very high prices. If we had had a cheaper method of distributing cash to shareholders, I think you wouldn't have seen some of those decisions made. Some of the acquisitions were simply made because the corporation had excess cash. They knew they were not supposed to give it to shareholders because that subjects it to extra taxation. So they acquired some other company.

Senator CORZINE. I don't think the technology industry or the folks that were creating software and all of the productivity growth would argue that their choice was holding it back for their own purposes or even in mergers. It was really to reinvest back into the growth in the economy. Objectively, I certainly hear that. I heard certainly here the principle of holding cash as the basis of investing.

Mr. MALPASS. Double taxation also causes unwise investments by companies. Every day a company is making a decision how much to invest in R&D. They have a choice: Should they dividend the cash or should they hire another scientist to try to invent something new? With the toll gate that we have right now, there is really no logical or rational way that the company can make that decision accurately. They are inevitably going to pay lower dividends. It stagnates the rotation of cash within the economy to have this toll gate.

Senator CORZINE. As you know, by the way, just on a factual basis, only about 50 percent of reported corporate earnings are taxed. The beneficiaries, when you use a divided exclusion, even by your own numbers, 50 percent of the American people have no participation in dividends. If you then look at IRAs, 401(k)'s, tax-exempt pension funds, you get the number of people actually benefiting from this so-called savings of double taxation down to about a quarter of the population of supposed dividend beneficiaries.

Mr. MALPASS. I do think it would change the capital structure and the distribution of taxation. We will see rotation within the equity ownership. I think what you gave there was somewhat of a static analysis. I think people who ought to own dividend-yielding stocks will rotate from less wise investments into wiser investments. I think you will get an efficiency gain within the economy simply from the rotation of ownership.

Right now a lot of people make investment decisions—you have to—on an after-tax basis. The double taxation of corporate earnings right now drastically distorts the decisions made on which stocks people own and how much cash a corporation holds.

Senator ENZI. Senator Bunning.

Senator BUNNING. Thank you very much. I have an opening statement. I would like to ask unanimous consent that it be put into the record.

Chairman NICKLES. Certainly.

[The prepared statement of Senator Bunning follows:]

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON THE BUDGET
STATE OF THE ECONOMY
JANUARY 29, 2003

THANK YOU, MR. CHAIRMAN.

I WAS VERY PLEASED TO SEE THAT YOU HAVE CHOSEN THIS TOPIC OF THE STATE OF THE AMERICAN ECONOMY FOR YOUR FIRST HEARING IN THIS COMMITTEE. ONE OF THE FIRST PRIORITIES OF CONGRESS AND THE ADMINISTRATION MUST BE TO HELP GET OUR ECONOMY BACK ON TRACK.

I FEEL THAT THE PRESIDENT'S RECENT TAX STIMULUS PROPOSAL WAS A GREAT START AND I LOOK FORWARD TO WORKING WITH THE ADMINISTRATION AND THE OTHER MEMBERS OF THE COMMITTEE UNDER THE LEADERSHIP OF CHAIRMAN NICKLES TO INCREASE THE HEALTH OF THE AMERICAN ECONOMY.

STATISTICS RELEASED YESTERDAY SHOWED NATIONAL UNEMPLOYMENT NUMBERS AT 6% WERE PARTICULARLY TROUBLING.

WHILE I AM HAPPY TO REPORT THAT THE UNEMPLOYMENT RATE IN THE COMMONWEALTH OF KENTUCKY IS BELOW THE NATIONAL AVERAGE, AT 5.4% IT IS STILL TOO HIGH. THAT 5.4% REPRESENTS FAR TOO MANY KENTUCKY WORKERS AND FAR TOO MANY KENTUCKY FAMILIES.

IT IS IMPERATIVE THAT WE WORK TOGETHER TO CREATE JOBS THROUGH IDEAS AND PLANS THAT WILL INCREASE THE HEALTH OF THE ECONOMY NOT JUST IN THE SHORT-TERM, BUT IN THE LONG-TERM.

IT IS THROUGH INCREASING BUSINESS INVESTMENT THAT THE ECONOMY WILL STRENGTHEN AND GROW.

I THANK OUR WITNESSES FOR THEIR WILLINGNESS TO SHARE THEIR EXPERTISE AND KNOWLEDGE WITH US TODAY AS WE CONTINUE TO EXAMINE THESE ISSUES.

I HAVE A NUMBER OF QUESTIONS AND I AM LOOKING FORWARD TO HEARING YOUR RESPONSES.

THANK YOU.

Senator BUNNING. I have a copy of the new CBO baseline update, and it shows that by the year 2007, we will be back to a balanced Federal budget. Even if the main elements of the Bush tax cut were made permanent, and even if the Bush growth plan were enacted, it appears that the budget would be balanced only 1 or 2 years later, by 2008 or 2009, under the baseline scenario. Adding the cost of Medicare expansion, a war, and other assumptions, of course, could put this date out farther.

I would like to ask a related question to the asbestos litigation. I understand that approximately $20 billion has been paid out by companies for claims and costs relating to asbestos litigation and that this number is estimated to reach as high as $275 billion. This issue is having an intense impact on some of the companies in my home State of Kentucky, with companies setting aside vast amounts of reserve cash to deal with this litigation. This is cash that could be used to improve capacity, grow businesses, and create jobs for Kentuckians.

Could you address the impact that this litigation is having on our overall economy? Could you comment on ways that Congress can help to mitigate—I know you have commented some—mitigate the negative effect of this litigation on the economy as a whole?

Mr. BAROODY. Senator Bunning, it is more like $54 billion that has already been spent.

Senator BUNNING. $54 billion instead of $20.

Mr. BAROODY. Yes.

Senator BUNNING. Thank you.

Mr. BAROODY. On dealing with the asbestos liability.

Senator BUNNING. What about the estimated reserves?

Mr. BAROODY. The estimated present and future liability totals, there are several estimates that exceed $200 billion, and $275 billion is a realistic and a reasonable estimate that concerns us a lot.

I have characterized that in my statement as an anchor on not just but primarily on the manufacturing economy's ability to grow as robustly as we ought to be growing at this stage in a recovery. We are doing—the overall economy is doing no better than half as well as it ought to be in this stage of a recovery, manufacturing even worse.

The overhang of that liability, the uncertainty that attaches to it, the necessity for companies to think about establishing the reserves you are addressing, all decrease the degree to which companies can be thinking about hiring, increasing wages, and making job-creating and productivity-enhancing investments in both the short and the long term.

The reason that the National Association of Manufacturers is a proponent, as I alluded to in my statement, of the President's proposal is that we think it looks both to the short and the long term on the tax side. We certainly need—we urge the Congress to look at the huge impact in the same terms, short and long term, that these inhibitors to growth that I have talked about and stressed in asbestos represent. They destroy jobs. They dry up the retirement savings of growing numbers, thousands and tens of thousands of people around the country, and they depress the economic well-being of the communities they operate in.

Senator BUNNING. They also put a lot of companies out of business.

Mr. BAROODY. That is correct. They throw them into bankruptcy.

Senator BUNNING. OK. One other question. The U.S. trade deficit is now running close to about $400 billion a year, nearly 4 percent of the gross domestic product. One explanation for this increase in the trade deficit is the effect of a strong dollar—or at least what used to be a strong dollar; it is kind of weakening as we go on—on both the price of products exported from the U.S. and products imported to the U.S.

Could you discuss whether the current prices of the U.S. dollar are in line with the economic fundamentals? If not, what steps should the Government be taking to bring the dollar more in line with the global currency markets?

Mr. BAROODY. Senator Bunning, we have spoken out, unapologetically, now for a year and a half or more about our sense—not that the dollar is strong or weak but that it is, in our view, overvalued and that the overvaluation of the dollar against all global currencies is having the impact you just identified and is contributing to the record balance of accounts problems that you identified in significant ways.

First, the good news is that the dollar has come down in its overvaluation against a basket of currencies by about 15 percent over the last 6 months or so. We are hopeful that that will be accompanied—first, that that trend will continue and it will be accompanied by growth globally——

Senator BUNNING. Well, but then explain to me why the deficits are continuing to accelerate as far as our trade is concerned.

Mr. BAROODY. Because that is——

Senator BUNNING. In other words, how much lag time is in there?

Mr. BAROODY. Well, we are just beginning to see something of a response on exports, and it is not enough yet. That is the first answer. There is a lag time. The second is that the 15-percent recentering of the value of the dollar goes perhaps half as far as our sense is that it needs to go. Against some of the Asian currencies, there continues to be a mismatch between what the market would set as the value of their currency relative to ours of 25 or 30 percent. So we have not yet seen the effect we call for in terms of revaluing the dollar according to market forces. What we have seen, while it goes in the right direction, has not been enough, and the lag times are just beginning to elapse sufficient that we will see some response.

I would make one other point. You asked what we would have done about it. Back in the 1980's, there was intervention on the value of the dollar. The National Association of Manufacturers is not calling for an overt intervention. We are calling for two things: first, that the rhetoric of our National Government about a strong dollar make the point that what we want—what we view as a strong dollar is one where the market sets the value. We have asked for the Administration to shift its rhetoric into neutral, is the way I put it. We applauded what the President said at the summit last summer, speaking about the need for the dollar to be set by market values, among other reasons, in the interest of a manufacturing recovery and competitiveness.

We would ask that our Government also encourage other foreign governments, including those I pointed to in Asia, to cease their own intervention, which tends to keep their currencies artificially low and ours artificially high.

Senator BUNNING. Last question for Mr. Sperling and Mr. Malpass. I am curious about your views toward capital gain tax reform. Do you support lowering or repealing the tax? Would you address the impact of capital gains tax cuts or repeal could have on the economy in the short term or long term as well? Either one.

Mr. SPERLING. Well, I guess the first thing I think we would probably all agree on is that whatever the benefits or dis-benefits of it, it would not be what you would call a stimulus proposal in the sense you are actually trying to encourage people to essentially save and invest more.

There has always been a lot of religion on this issue. To me, there is very little to suggest that further lowering of the capital gains tax would have any noticeable benefits on our economy. As you know, in 1997, we did have a bipartisan agreement to lower the capital gains, and we went along with that. As you know, President Clinton signed that. I at this point would not see a reason to go further.

My more basic point, sir, is that I think whenever we——

Senator BUNNING. I don't want to interrupt, but I want you—what was the spike when capital gains was reduced by 8 percent in the revenue for the United States Government? There was a huge spike. I think it was close to $65 billion.

Mr. SPERLING. Well, Senator, nobody disagrees that there was—that the late 1990's were a tremendous economic period in terms of revenues coming in and investment. We had the unusual situation of the longest expansion in history actually growing strong, growth and higher productivity near the end. I myself would attribute that more to kind of more sound fundamentals in terms of fiscal discipline, I think wise monetary policy, than the capital gains reduction per se. The comment I was going to make is that I think the important thing when doing tax cuts is to calculate in not just whatever marginal incentives they may have, but the potential negative impacts that one has from raising the deficit, and to make one's calculations in that way.

So, for example, on dividend exclusion, I would think that an overall corporate tax reform in which dividends were taken care of in a way that did not raise the deficit——

Senator BUNNING. You are not getting to my question. You have given——

Mr. SPERLING. I am sorry, Senator.

Senator BUNNING. I asked you about capital gains, and now you are on dividend exclusion.

Mr. SPERLING. I am sorry, sir. I do not personally nor do I think that many people would attribute the strong increase in capital gains or revenues significantly to the cut in capital gains we had in 1997.

Senator BUNNING. Thank you.

Mr. Malpass, do you have an opinion on that? I am finished.

Mr. MALPASS. I think there was a direct effect. As you lower the rate of tax on something, you get more of it. If you lower the capital gains tax, you are going to get more capital gains. That is one of the factors that we saw.

We saw another example. Congress in its wisdom lowered the capital gains taxation on houses in roughly 1997. What we saw was the value of houses go up and the number of houses go up. The same analogy would apply to equities.

The value of a given equity is the after-tax value. If you lower the capital gains tax wedge that is in there right now, the equity market is going to respond favorably to that.

We are in a situation right now where a lot of people have capital gains loss carry-forwards——

Senator BUNNING. I guess we do.

Mr. MALPASS. If you lowered the capital gains tax rate right now, the Government wouldn't even lose very much in the short run. I think you get even more of a benefit right now this year from a capital gains tax cut than you would have, say, in the peak period in 1999.

Senator BUNNING. Thank you very much, Mr. Chairman. All I can say is that for the first time we have a positive scoring estimate on lowering the capital gains tax rate by CBO and OMB.

Chairman NICKLES. Thank you, Senator Bunning. I am just looking at the history of capital gains receipts, and it is pretty significant increases that happened after the tax reduction from 28 to 20 percent. It is also a pretty significant reduction in the revenues. Actually, this is startling. From 2001 to 2002, revenues on capital gains went from 97 to 55. That is a $42 billion decrease and almost a 45-percent reduction, something like that, very significant.

Senator SARBANES. Were the rates increased at that time?

Chairman NICKLES. No.

Senator BUNNING. No. There weren't any profits.

Senator SARBANES. The rates stayed the same, so it was the economy that did that, I take it.

Chairman NICKLES. Yes, there was a 45-percent reduction in Nasdaq in the year 2000 that had something to do with that, and I had some of those that crashed as well. [Laughter.]

Chairman NICKLES. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, and thank you to each of you for coming and speaking to the Committee today.

I wondered, Mr. Baroody, coming from the great manufacturing State of Michigan, if we might talk a little bit about pressures on manufacturers for a moment. I am proud of what we make in Michigan, not just automobiles but refrigerators and washing machines and all kinds of things. I happen to believe that the economy is based on making things and that a manufacturing base is critical to the United States economy.

I would agree with you that asbestos is an issue that has to be addressed, and I would encourage the Judiciary Committee to do so.

Where would you rank health care costs to your members right now as a pressure on your bottom line?

Mr. BAROODY. It is a huge and durable concern that has sort of come back with a vengeance, if I could put it that way, in the last

2 or 3 years. Increasingly our members, and especially our smaller members—the majority of NAM members are small—are reporting double-digit health coverage cost increases again. We had hoped in an earlier period that we had seen the end of that. Unfortunately, we haven't seen it. It is coming back very hard, and it is prompting the squeeze I talked about. If you can't raise prices but your costs go up, in this case health care costs, something has got to give. The response from a growing number of our members is that they have had to require of their own workers a greater copay, a greater premium share if they have any hope of maintaining coverage.

Senator STABENOW. I am hearing the same thing, and nationally we are seeing the average costs of health insurance has risen 12.7 percent just in the last 2 years. In talking with manufacturers in Michigan, for instance, Daimler-Chrysler shared with me that they are now spending more on health insurance than they are on purchasing the raw materials for the vehicles.

What was interesting to me is that about half of that cost is the explosion in prescription drug prices, and I wanted to note that as, Mr. Chairman, you spoke about having the second highest dividend taxes, we pay the highest prescription drug prices, our businesses and our individuals, of anywhere in the world. I would suggest that we have to tackle that. The average brand name product is going up three times the rate of inflation.

So when we look at where we ought to be addressing cost issues for manufacturers, for other businesses, as well, as you said, for employees—they are paying higher copays or maybe taking a pay freeze so their employer can maintain their insurance policy—this is a huge squeeze both to workers and families as well as businesses. I would hope that as we are debating what we are doing in terms of the budget and the economy that we would include health care costs as a part of that.

I am wondering, we have been attempting to increase competition through greater use of generic drugs and other opportunities to lower prices, and I certainly would encourage the manufacturers to be involved in that debate. I am sure you are.

Mr. BAROODY. Yes, ma'am.

Senator STABENOW. This is a major issue in terms of a drain and a squeeze on the economy right now. I would suggest as well in terms of double taxation, you have people paying the payroll tax, seniors who have paid it all their lives who now are on top of that having to struggle with their prescription drugs because it is not a part of Medicare. So there are a lot of ways in which people are taxed doubly and pressured doubly and triply with that.

I would like to ask about another kind of proposal. I am a proponent of doing something immediately. I put in legislation last time to create a major bonus depreciation and believe in stimulating the economy immediately in terms of investment. I certainly want to support efforts to do that. An effort that has been supported by the Business Round Table and others has been the idea of a payroll tax cut or refund based on the payroll tax. I am wondering if the manufacturers have looked at that and taken a position.

Mr. BAROODY. Ms. Stabenow, we have looked at it. We have not included it in our priority approaches or recommendations to this

Congress or to the Administration about stimulus—or, we think more accurately, the term "growth"—provisions.

If you would indulge me, we put it this way: We are not sure at the NAM that we or anyone else really knows how to stimulate an economy that is this large and this traumatized. The effort to accumulate a number of short-term provisions is, we think, bound to be complicated and the payroll tax provisions would be complicated particularly, again, for a lot of smaller employers like our small manufacturers.

Also, we think that proposals that can promise some short-term effect and do so in a way that builds toward a stronger and more durably growing long-term effect are the ones we would prefer. That is why we are so enthusiastic about marginal rate cuts as opposed to temporary provisions to try to put—to accelerate demand by putting money immediately in people's pockets.

That is also why we did favor and recommended an end to the double taxation of dividends. Frankly, we would have preferred it on the corporate side and have done a lot of analysis over the years indicating to us that that could have a very big growth impact if it were enacted. Certainly on the expensing side for small manufacturers, we are very encouraged by the proposals that I think both parties are talking about in terms of increasing depreciation or expensing for small manufacturers.

When we looked at all the possible proposals, we ended up prioritizing first the three provisions I just talked about—end of double taxation, acceleration of marginal rate cuts, and something to spur business investment over a longer period of time than just 1 year—rather than looking at the payroll tax provisions or ideas that others have talked about, including the BRT.

Senator STABENOW. Mr. Sperling, would you like to respond to the proposal I know that has been introduced in the Senate relating to payroll tax really both for business and for workers?

Mr. SPERLING. As I said, I think that as an insurance policy there is adequate justification for a one-time injection of funds. It is a stimulus policy. I have in the past hoped that such could have been timed in 2001 and 2002 with the Christmas shopping season where I think people would be more likely to take their check and spend it, and perhaps had we had that, it could have prevented us from having the weak Christmas shopping season we did.

I think the level—I think it becomes highly complicated, however, to actually try to month by month change withholding. So my belief would be that it would be better to do it as a single rebate check off last year's payroll. I personally would limit it to the employee side so that it would be more focused on getting demand going. That is where I believe we have our greatest weakness.

I guess my final comment, which I was trying to make before, is that whenever we judge these tax cuts, we do have to look at the full—you know, Chairman Nickles talked about you have to look at the full picture. The full picture is simply that you have to recognize that there are positives, perhaps in demand, perhaps longer-term work incentives, but there are also negatives when the deficit rises and we crowd out private sector savings.

In 1997, we did things like capital gains and other things in the context of a balanced budget plan that actually increased fiscal discipline. So on all of these discussions, I would just encourage people not just to look at one side of the coin but look at the balance. My feeling is if it is one time only and it helps stimulate the economy, it will not have a long-term impact, it is worth the risk. When things are going to have longer-term permanent impacts on our deficits in the decade where we need to be saving more to deal with the long-term entitlement challenge coming, then I think it is incumbent upon us to do a more comprehensive analysis of the benefits of the tax cut weighed against the disadvantages of hurting our national savings.

Senator STABENOW. Just a closing comment, Mr. Chairman, if I might. I find it so interesting, the debates that we have in theory in terms of how to stimulate the economy and how to create growth when we have, I would reiterate—and I have said this before. We have two examples, actually going on three now, of differences, one worked, one didn't. The 1980's was very much a supply side approach, relieving those at the higher incomes, hoping that will trickle down. We saw massive increases in national debt, explosion on interest rates. The 1990's was different. In 1997, I was in the House when we balanced the budget for the first time in 30 years, a focus on slowing spending, on balancing the budget, paying down the national debt, and focusing on education and innovation spending.

Now we are back to policies that look more like the 1980's, and if this was just a theoretical discussion, I guess it would have more impact on me. We have practical realities of what worked and what hasn't worked. I would hope that we would focus on what has worked because it was very significant in the 1990's.

Chairman NICKLES. Senator Stabenow, thank you very much.

Senator Allard, I apologize. I noticed that you came very early and then stepped out and maybe got lost in the queue and maybe because I stepped out as well. So I apologize for that, but you are next and thank you.

Senator ALLARD. Well, Mr. Chairman, no concern on my part, and I am just glad to be here on the Committee. I apologize for having to step out, and I missed the testimony from Mr. Baroody and Mr. Sperling.

I did appreciate the testimony that Mr. Malpass provided us with, and you talked about an increase in personal spending. The question that came to my mind: What was happening with business spending? I had read reports where business spending had come down. I didn't see in your comments or the report that you were putting here for the Committee where you talked anything about business spending. I would like to have you comment on that, if you would, please.

Mr. MALPASS. Business spending in the 1990's grew strongly. In fact, in some areas——

Senator ALLARD. In the recent time period.

Mr. MALPASS. In 2002, we were in a recovery. People are often saying that there was simply no business investment going on. That is actually not the case.

There was a crash in aircraft spending. Taking that out, almost all other sectors of business equipment saw growth in 2002. U.S. equipment investment, was $954 billion in the first quarter of

2002. That compared to $452 billion for the whole European Community. I think it is important that people put in perspective the magnitude of the U.S. economy, even in 2002, which we think of as a weak recovery. Every quarter our investment was roughly double what Europe was doing. That really has a powerful implication for productivity growth into the future.

Senator ALLARD. So the business spending and the personal spending, pretty much the same?

Mr. MALPASS. Consumption, unlike previous recessions, didn't dip in 2001. Business spending often takes off in the second year of a recovery. It didn't do that this time. Overall business spending versus a normal recovery was weaker than the normal jump.

Senator ALLARD. So your conclusion is that we need to do something to stimulate some business spending. Is that your conclusion?

Mr. MALPASS. Yes, certainly. I would be happy with stimulus or growth measures. If you create a good environment for the economy, that is a stimulus in the near term because people anticipate the better future.

What I think would be important is to create a good climate long term for investment. That is going to cause people to buy equipment today.

Senator ALLARD. So you are of the view that if we would take away the double taxation on dividends, that would be a stimulus for business spending.

Mr. MALPASS. Correct. It's both a near-term and long-term stimulus. There really is no difference in my mind between what is a stimulus and what is a growth-oriented change in the Tax Code. They are both going to operate the same because people look ahead.

Senator ALLARD. Now, I read over the President's proposal on reducing the double taxation on dividends. There is a lot of paperwork—I see a considerable amount of paperwork that is involved because you take how you are going to carry that over to the individual stockholders, and if there is—particularly a company has said part of it is going to be subject to double taxation and part of it will not be on your dividends, then you have percentages that have to be carried over into all your allocation distributions to your shareholders.

Do you view that as a significant disadvantage for business that they would not respond to that increased recordkeeping requirement?

Mr. MALPASS. As you change the Tax Code, there are always consequences.

Senator ALLARD. Yes.

Mr. MALPASS. Some of them are a 1-month cost in terms of programmers.

As I have heard it explained, the 1099 form that people now get can be changed to show tax-free dividends and also deemed dividends. What we are talking about is enough computer programming so that when you get that year-end statement, it shows some additional information.

Senator ALLARD. So with the age of computers, you think it is a very workable solution then?

Mr. MALPASS. I can't speak for Bear Stearns on that. We are a huge paperwork generator. I don't know our position on that. I have heard the Administration talk about the paperwork requirement, and it sounds to me like it is quite manageable.

Senator ALLARD. Yes, OK. I just want to say, Mr. Baroody, it is good to hear you say that you didn't want to see a lot of intervention on your question here to Senator Bunning about the value of the dollar. I am, I think, of like-minded view. I want to see the markets carry that value of the dollar. I would just add on top of your comment that when our trade deficit has been most favorable has been during the Great Depression, and also during the end of the 1970's when we had the misery index, and that is when our trade deficits were most favorable. I have always felt that trade deficits actually reflected the condition of the economy, and if the economy was doing good, we bought more goods and services, and so our trade deficit would change. Could you comment on that?

Mr. BAROODY. Senator, our concern is not so much with the imbalances in the deficits. Obviously that is a symbol of the concern, but it is much more hard-edged than that. Companies which make heavy equipment find that they are at a 10, 15, 25 percent cost disadvantage with their global competitors for only one reason: the imbalance in the dollar.

Senator ALLARD. Yes.

Mr. BAROODY. If the market would be allowed to set the value of that dollar, that imbalance and disadvantage would go away. Our exports would rise. Our exports-dependent employment, which are all very good, highly skill-demanding, but highly rewarding jobs, would also rise.

So, yes, we are not talking about some Machiavellian intervention. We are talking about letting the market set the value of global currencies, including but not limited to the dollar. If we do that, a lot of manufacturing's exports problems get ameliorated significantly.

One point. I mentioned the distinction between this recession we are coming out of and all the previous ones. Contrast it with the one of 10 years ago, similarly characterized as relatively mild, and not with the same adverse impact on manufacturing I reported to you today. One of the reasons was that even during that 1990-91 recession, export growth by the United States held up at about 7-percent rates. In this recession, export volume actually declined, and we think it declined primarily because of the value of the dollar.

Senator ALLARD. One more question, if I might, Mr. Chairman. Mr. Malpass, you had a question over here from my colleague about a refund or some kind of reduction in the payroll taxes. Most of the payroll tax is Social Security. That has got to have an impact on the Social Security Trust Fund, wouldn't you say? So, in effect, we are taking money right out of Social Security with that proposal.

Mr. MALPASS. That has been confusing to me. Right now, as people pay Social Security tax and their employer pays it, it goes into the trust fund. So if there were a holiday, it seems as if it would stop the buildup.

Senator ALLARD. Have an adverse impact on Social Security.

Mr. MALPASS. So I guess I haven't understood that. From an economic point of view, the question is: Will you get much bang for the buck out of a short-term tax cut like that where everybody knows that the rates are going to go right back up? My view is that you won't.

Senator ALLARD. Mr. Chairman, thank you.

Chairman NICKLES. Senator Allard, thank you very much.

Next we have Senator Sarbanes.

Senator SARBANES. Thank you.

Chairman NICKLES. Senator Sarbanes, thank you as well for—how many years on the Committee?

Senator SARBANES. I stopped counting.

Chairman NICKLES. Twenty-some?

Senator SARBANES. No, I haven't been on it that long.

Chairman NICKLES. Not that long. Well, anyway, welcome.

Senator SARBANES. Mr. Malpass, do you support an amendment to the Constitution of the United States to require a balanced budget?

Mr. MALPASS. Senator Sarbanes, in 1997, I testified on that. In my testimony at that time, I went through quite a few of the economic issues that I think are important. I don't know where I stand right now. I guess my view of this is that is very important that Congress restrain the growth rate in spending. That is where my focus is right now.

Senator SARBANES. At the moment do you support an amendment to the Constitution to balance the budget?

Consistent with your 1998 position?

Mr. MALPASS. I haven't thought about it.

Senator SARBANES. You support President Bush's economic program, which would increase the deficit. Is that correct?

Mr. MALPASS. I have thought a lot about that. I support the program because I think it would be stimulative to growth.

Senator SARBANES. It will increase the deficit.

Mr. MALPASS. Well, in the long run, no. It is going to reduce the deficit by creating a better capital structure for the U.S. I think our focus has to be on how do we get out of this debt——

Senator SARBANES. Well, will it create a deficit in the short run?

Mr. MALPASS. I think it will increase the deficit depending to some extent on the growth response that we get in that first year.

Senator SARBANES. If we had a constitutional amendment requiring a balanced budget, as you advocated only a few years ago, we wouldn't be able to do President Bush's economic program, would we?

Mr. MALPASS. The proposals that were before Congress at that time, it seems to me, had exceptions for war and for other things. So I don't know—I think the exceptions may have been triggered by our current situation.

Senator SARBANES. I don't think so, but we can go back and check that.

Mr. Baroody, do you support a constitutional amendment requiring a balanced budget?

Mr. BAROODY. Senator Sarbanes, I believe that the NAM has had for some time on its policy books support for such an amendment. It is not a current category of our—I alluded to our pro-growth, pro-manufacturing policy agenda. We don't mention that in it and haven't in recent agendas.

Senator SARBANES. You support President Bush's economic program?

Mr. BAROODY. We do.

Senator SARBANES. How would one do that if there was a constitutional amendment requiring a balanced budget? You wouldn't be able to do it, would you?

Mr. BAROODY. To be candid, Senator Sarbanes, I think you may be right, and we haven't thought about that in terms of the two together. What we have thought about is our own sense of the need for the manufacturing sector to contribute to—excuse me, to participate in this recovery.

Senator SARBANES. Well, I have been very sympathetic to the manufacturing sector.

Mr. BAROODY. Yes, sir, we know.

Senator SARBANES. I think it is important now to draw out this obvious inconsistency. The NAM, in reacting to President Clinton's speech, says, "The NAM believes that a constitutional amendment requiring a balanced budget will ensure fiscal soundness," and came out in support of it. Now, that seems to have gone by the bye, as you have just said. It is not really on your current agenda. I am just trying to get at the point that what is sauce for the goose is sauce for the gander.

Mr. BAROODY. It is a fair point——

Senator SARBANES. Mr. Sperling, do you support a constitutional amendment requiring a balanced budget?

Mr. SPERLING. I do not support a constitutional amendment. I do, however, support Congress through its own mechanisms seeking to have the kind of pay-as-you-go standards that help lead to balanced budgets and to helping to save for us to deal with the long-term entitlement challenge.

Senator, I think the main point that you are pointing to is the most profound. The swing in what was the mainstream view on deficit reduction and balanced budgets over the last 2 or 3 years is profound. As you will recall, in the late 1990's there was almost a complete bipartisan commitment not only to balancing budgets, as you recall, but to actually saving the surpluses that come from Social Security for debt reduction. There was significant notions that new programs, however worthy, whether prescription drugs or tax cuts, had to have offsets that would be consistent within a balanced budget structure. I think it will be to our country's great long-term disadvantage that we have moved so far away from what was so recently a bipartisan consensus.

Senator SARBANES. Yes, but that consensus was not on an amendment to the Constitution. That consensus was on taking a series of measures that would achieve greater fiscal soundness.

Mr. SPERLING. You can see from right now that the balanced budget amendment is in some ways too strict, but then not loose enough—I mean, but not good enough in some ways in the sense you would not want to be constrained in a temporary moment like this where you face war or even economic weakness. The balanced budget actually only allowed you an escape clause at, I think, 1 percent growth, and it would be very difficult to tell when that was coming. So our view was that Congress, through responsible policies, as we saw when there was split Government in the late 1990's, was able to achieve that with that commitment, but without a constitutional mandate.

Senator SARBANES. Now, Mr. Baroody, Jerry Jasinowski, the president of the NAM, testifying before the Senate Banking Committee last May, said, and I quote him: "The overvaluation of the dollar is one of the most serious economic problems now facing manufacturing in this country. It is decimating U.S. manufactured goods, exports, artificially stimulating imports, and putting hundreds of thousands of American workers out of work."

I, in fact, agree with this concern of the NAM, and have over quite a period of time. The Treasury Secretary nominee yesterday said, "A strong dollar is in the national interest." When is the NAM going to be able to find some important administration support for its concern? It is very clear that some of our competitors are manipulating the currency in order to gain a trade advantage—I would put China forward as Exhibit Number One, but they are not the only ones. How are we going to address this situation?

Mr. BAROODY. Senator, first, we are not for a weak dollar. We think that the——

Senator SARBANES. No, we are not for anything that is weak. We can't be for anything that is weak. That is for sure.

Mr. BAROODY. The appropriate term would be "a market-valued dollar," and we have found some—and I alluded to it earlier in the discussion with Senator Allard. We have found someone authoritative in the Administration who has articulated the same view. I was going to fumble to see if I had the quote directly. Forgive me. President Bush, as I alluded, at a summit late last summer or early fall, made exactly the statement that you and I would agree on, I think, that the market should set the value of the dollar and that we must see to that, among other things, in the interest of enhancing manufacturing's ability to compete.

Senator SARBANES. Well, that is what we keep saying, but how do you then deal with the problem where you say the market is going to set the value——

Mr. BAROODY. Yes.

Senator SARBANES. One of your prime competitors is not allowing the market to set the value of the currency but is intervening in a lot of very shrewd and skillful ways in order to affect the valuation and thereby they gain—I forget the percentage figure—20 percent, I think you said.

Mr. BAROODY. Well, it depends on the product and the country and currency we are dealing with.

Senator SARBANES. Right. Well, now how do you deal with that problem?

Mr. BAROODY. Good question.

Senator SARBANES. You say, well, we don't intervene in the market, we want the market to set it. Fine. I accept that. The other fellow is intervening in order to affect the valuation. Now, how do you deal with that situation?

Mr. BAROODY. Not easily. I mean, first of all, we have asked for the Administration, as I have said, to shift its rhetoric into neutral. We have insisted we are not asking for intervention, but I think the corollary to that—and the Administration understands that this is our view—is that if we are not going to seek intervention by our own Government and currency exchanges, we do want our Government consistent with that to speak out against interventions by other countries when they do it.

You are right, people more versed in the currency markets than I would tell you that perhaps you could add up three or four Asian countries over the last 3 or 4 years and find that they have made purchases exceeding $400, maybe even $500 billion of dollars for the sake of continuing this imbalance.

We think that the world trade and international investment needs to be governed by rules. The WTO provides some rules. We want to see through those mechanisms that companies which are intervening in this way are powerfully induced to cease so that the market can set these rates.

Senator SARBANES. Well, that is nice phrasing, "powerfully induced," and I accept that.

Mr. Chairman, thank you very much. I just ought to close by observing it is really fascinating to watch those who were such vehement advocates of an amendment to the Constitution to require a balanced budget—and it extends quite widely, this circle having relegated that to the mists of the past as they now support substantive proposals from the Administration that will, in fact, contribute to the deficit. My own view is that we need to run a deficit, at least in the current fiscal year, in order to try to give a boost to the economy. So I accept that. I am not in favor of building in the long-term deficit over subsequent years because I think we ought to wait and see and make those judgments as we move into those years in terms of the economy in order to try to maintain some semblance of fiscal discipline. There are a lot of people around here who were screaming only a few years ago to amend the Constitution and have a balanced budget, and that is all simply gone by the board.

I thank the Chairman.

Chairman NICKLES. Senator Sarbanes, thank you very much. To our panelists, I want to thank you as well.

We will have our next committee hearing tomorrow morning at 10 o'clock. We will have Barry Anderson, who is Deputy Director of CBO, also as our principal witness. They just came out with their budgetary and economic outlook today, so that will be the subject of our hearing.

To our panelists, thank you very much. I think this has been very informative and very helpful to us as we try and put together a package that will grow the economy. So thank you all very much.

Mr. SPERLING. Thank you, Mr. Chairman.

Mr. BAROODY. Thank you, Mr. Chairman.

Mr. MALPASS. Thank you, Mr. Chairman.

Chairman NICKLES. Thank you.

[Whereupon, at 12:16 p.m., the committee was adjourned.]

Presentation for "Understanding Asbestos Litigation: The Genesis, Scope, and Impact" at the U.S. Chamber of Commerce
January 23, 2003

The Impact of Asbestos Liabilities on Workers in Bankrupt Firms

Jonathan M. Orszag

SEBAGO ASSOCIATES

Purpose of Study

Asbestos claims have skyrocketed over the past decade.

These claims are pushing many companies into bankruptcy or at least to the brink of filing for bankruptcy protection.

The current system of paying asbestos claims imposes significant costs not just on businesses, but on their individual employees. Wages, future employment prospects, and the ability to save for retirement are all affected.

The purpose of this paper is not to suggest in any way that impaired claimants are unworthy of assistance, but rather to highlight the fact that payments to claimants are not free and to illuminate some of the costs imposed on workers as a result.

This presentation is based on a paper I authored jointly with Joseph Stiglitz (the co-winner of the 2001 Nobel Prize in economics) and Peter Orszag. The paper was commissioned by the American Insurance Association.

Background Facts

At least 600,000 individuals have filed claims related to asbestos exposure.

In 1983, RAND estimated that 300 firms had been listed as defendants in asbestos cases. RAND now estimates that more than 6,000 independent entities have been named as asbestos-liability defendants

The acceleration in claims does not appear to be associated with an acceleration in the number of severely affected people.

- The American Academy of Actuaries has concluded that about 2,000 new mesothelioma cases are filed each year, a flow which is largely unchanged over the past decade.

RAND estimates that aggregate outlays for asbestos claims total $54 billion. Looking to the future, most analysts believe that the number of claimants and total outlays for claims will continue to rise.

- Tillinghast-Towers Perrin, an actuarial consulting firm, projects that 1.1 million claims will eventually be filed, with the total cost to defendants and insurers amounting to $200 billion.
- Milliman USA, another actuarial consulting firm, also forecasts 1.1 million total cumulative claims, but it projects that higher total costs ($275 billion).

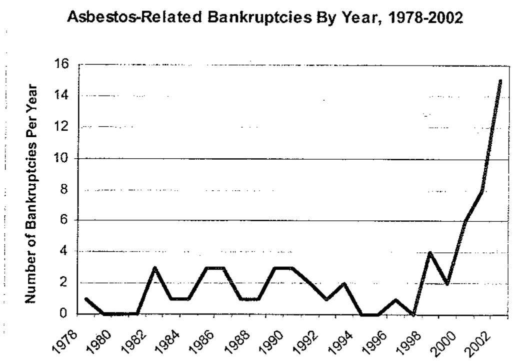
Asbestos Claims Have Pushed An Estimated 61 Firms Into Bankruptcy

We compiled a list of bankrupt companies from a variety of sources.

After compiling this list, we imposed filters to limit our sample to U.S. firms for which asbestos liabilities played a substantial role in causing the bankruptcy.

We estimate that 61 companies have faced significant asbestos liabilities and have filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code as a result.

Asbestos-Related Bankruptcies Have Accelerated In Recent Years



One quarter of <u>all</u> firms that have filed for bankruptcy due to asbestos liabilities have done so in the past 10 months; nearly sixty percent have filed in the past five years.

Bankrupt Firms Employed More than 200,000 Workers

We compiled a database of employment for 40 of the bankrupt firms; data were unavailable for the other bankrupt firms.

The firms for which we have data employed more than 200,000 workers the year before they filed for bankruptcy.

Number of Asbestos-Related Bankruptcies and the Number of Workers Employed By the Firms, By Time Period		
Time Period	Bankrupt Companies For Which We Have Employment Data	Number of Workers Employed By Bankrupt Firms Year Before Bankruptcy Filing
"First Wave": 1978-1985	2	30,600
"Second Wave": 1986-1993	13	37,365
"Third Wave": 1994-1997	1	72
"Fourth Wave": 1998-2002	24	136,831
Total	**40**	**204,868**

Bankrupt Firms Are Diverse, In Terms of Industry Group and Geographic Presence

Companies facing asbestos liabilities are not concentrated in a particular industry.

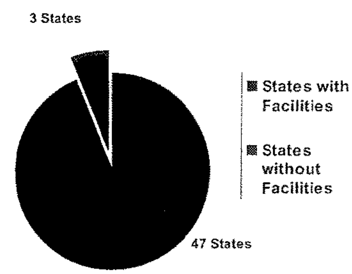
- RAND concluded that "litigation has spread to touch firms in industries engaged in almost every form of economic activity that takes place in the American economy."

Bankrupt companies are currently headquartered in 19 different states.

- Pennsylvania – which contains heavy concentrations of manufacturing firms -- accounts for almost a quarter of the bankrupted firms

The bankrupt companies have (or had) facilities in 47 states. The only states without a facility are (were) Hawaii, North Dakota, and Rhode Island.

States with and without Facilities of Asbestos-Related Bankrupt Companies



Bankrupt Firms Tend To Be Highly Unionized

Many of the firms declaring bankruptcy report particularly high unionization rates in their SEC filings.

Johns-Manville reported that 42 percent of its workers were unionized in 1981, the year before it declared bankruptcy.

Other bankrupt firms also report high unionization rates for the year before they filed for bankruptcy:

- Eagle-Picher reported a unionization rate of 33 percent;
- Federal Mogul reported 33 percent;
- Armstrong reported 57 percent; and
- Todd Shipyards reported 75 percent.

Impact of Bankruptcy on Employment

After adjusting for the changes in industry employment, the firms for which we have data lost 51,970 jobs in the five years prior to bankruptcy.

Assuming that employment losses at the firms for which we lack data were proportionate to those for which we have data, the implied total employment loss would be roughly 60,000.

Change in Employment in Five Years Prior To Bankruptcy After Controlling for Changes in Industry Employment	
	Number of Lost Jobs
Firms Filing for Bankruptcy Before January 1998	24,551
Firms Filing for Bankruptcy After January 1998	27,419
Total for Firms With Data	**51,970**
Estimated Scaled Total For All Bankrupt Firms	**~60,000**

Other Costs of Layoffs: $25,000-$50,000 Per Laid-Off Worker

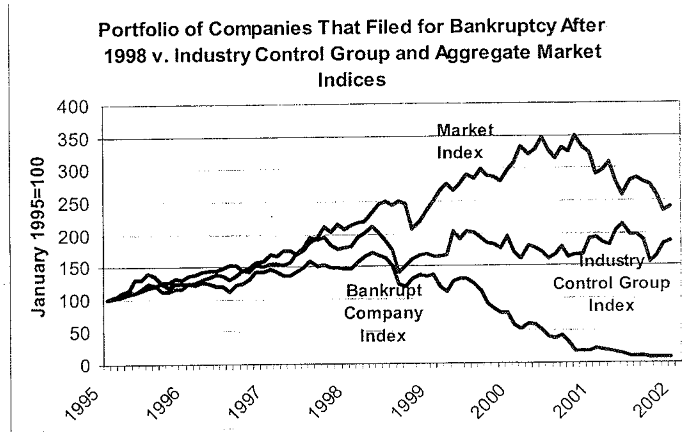
The economic costs resulting from the dislocation involve two components:

- First, under reasonable assumptions, the unemployment spells associated with the displacements would represent an economic cost of about $175 million to $200 million.
- Second, displaced workers tend to earn lower wages at their new jobs, reflecting the loss of human capital associated with the displacement. A recent academic study estimated that the loss in earnings from displacement amounts to between 5 and 10 percent of previous wages. Assuming that the average displaced worker is 45 years old, and has 20 years to retirement, the present value of the losses in wage income would amount to between $1.2 billion and $2.8 billion at a five percent real discount rate.

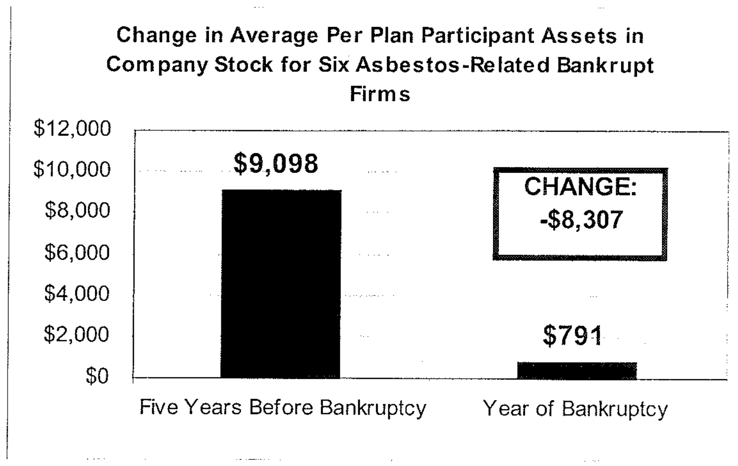
The total economic costs associated with the displacements under these assumptions would then amount to between $1.4 billion and $3.0 billion.

Thus, each displaced worker at the bankrupt firms will lose, on average, an estimated $25,000 to $50,000 in wages over his or her career because of periods of unemployment and the likelihood of having to take a new job paying a lower salary.

Stock Prices of Bankrupt Companies Have *Underperformed* Industry Control Group and the Overall Market



Workers' Retirement Assets Have Suffered As A Result: Average Loss of $8,300 (or Roughly 25%)



Loss of Retirement Assets Causes Substantial, Albeit Perhaps Not Devastating, Costs on Workers

Impact of Loss of Pension Wealth on Measures of Retirement Security	
	45-year old worker
Increase in required 401(k) saving per year to maintain pre-reduction retirement income ($2002)	$720
Reduction in retirement assets ($2002)	$23,807
Reduction in annual after-tax retirement income ($2002)	$1,250
Delay in retirement age to maintain pre-reduction retirement income per year (years)	0.83

Direct Costs of Bankruptcy: Between $325 Million and $650 Million

Based on the earlier literature, a conservative estimate is that the direct costs of bankruptcy amount to between 3 and 6 percent of the firm's market capitalization.

Since the aggregate market capitalization one year prior to bankruptcy (in July 2002 dollars) for the 12 companies for which we have data was $7.2 billion, the direct costs associated with these asbestos-related bankrupt companies will total between $225 million and $425 million.

These 12 firms represented about two-thirds of employment at the bankrupted firms as a whole; if the ratio of market capitalization to employment were the same for the other bankrupted firms as for these 12 firms, the total direct costs would amount to between $325 million and $650 million.

Asbestos Liabilities Have Also Imposed Costs on Non-Bankrupt Firms

This paper focuses primarily on the costs associated with firms declaring bankruptcy because of asbestos liabilities.

It is important to emphasize that the bankruptcies do not capture the full effect of asbestos liabilities on defendants to date, nor do they reflect the future costs imposed from ongoing litigation.

We have not attempted to quantify the economic effects of asbestos claims against firms that have not (or not yet) declared bankruptcy.

Among the companies facing such claims are a major paper and forest products company, a major media conglomerate, and leading transportation firms. For example:

- The major media conglomerate reported 118,000 asbestos claims outstanding against it as of June 30, 2002 -- and during the second quarter of 2002 alone, it received 9,700 new claims.
- One major industrial firm, which never produced or sold asbestos, faces as many as 74,700 claims because its "dust masks" did not adequately protect against asbestos.

The uncertainty surrounding such claims raises borrowing costs and reduces equity values for the firms, thereby impeding their activities. It may also discourage firms from merging, even when such mergers would make economic sense.

Conclusions

We estimate that:

- Bankruptcies led to a loss of an estimated 52,000 to 60,000 jobs;
- Each displaced worker at the bankrupt firms will lose, on average, an estimated $25,000 to $50,000 in wages over his or her career because of periods of unemployment and the likelihood of having to take a new job paying a lower salary; and
- The average worker at an asbestos-related bankrupt firm with a 401(k) plan suffered roughly $8,300 in pension losses, which represented, on average, a roughly 25-percent reduction in the value of the 401(k) account.

In light of these costs, re-examining the system used to compensate those who file asbestos liability lawsuits seems worthwhile.

THE IMPACT OF ASBESTOS LIABILITIES ON WORKERS IN BANKRUPT FIRMS

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COMMISSIONED BY THE AMERICAN INSURANCE ASSOCIATION
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About This Study

This study was commissioned by the American Insurance Association as an independent analysis of the costs borne by workers of firms filing for bankruptcies due to asbestos liabilities.

The views and opinions expressed in this study are solely those of the authors and do not necessarily reflect the views and opinions of the American Insurance Association or any of the institutions with which the authors are associated.

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Executive Summary

Asbestos claims have skyrocketed over the past decade. These claims are pushing many companies into bankruptcy or at least to the brink of filing for bankruptcy protection.

The pain and suffering of impaired asbestos claimants are palpable and undeniable. It is important to realize, however, that the current system of paying asbestos claims imposes significant costs not just on businesses, but on their individual employees. Wages, future employment prospects, and the ability to save for retirement are all affected. The purpose of this paper is not to suggest in any way that impaired claimants are unworthy of assistance, but rather to highlight the fact that payments to any claimants are not free and to illuminate some of the costs imposed on workers as a result.

We estimate that 61 companies have filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code as a result of asbestos liabilities. These companies are spread across the nation, with 47 states having at least one asbestos-related bankruptcy. Many of the workers at these companies – which employed 204,868 people the year before they filed for bankruptcy – are members of unions, and they are often shareholders in the companies as well as employees.

The bankruptcies associated with asbestos liabilities have had a marked deleterious effect on workers in those firms. For example, we found:

- Bankruptcies led to a loss of an estimated 52,000 to 60,000 jobs;
- Each displaced worker at the bankrupt firms will lose, on average, an estimated \$25,000 to \$50,000 in wages over his or her career because of periods of unemployment and the likelihood of having to take a new job paying a lower salary; and
- The average worker at an asbestos-related bankrupt firm with a 401(k) plan suffered roughly \$8,300 in pension losses, which represented, on average, a roughly 25-percent reduction in the value of the 401(k) account.

The bankruptcy event itself is costly, since the legal, accounting, and other transaction costs associated with a bankruptcy can be significant. Based on the published literature on the topic, the direct costs of bankruptcy amount to between three and six percent of the firm's market capitalization. This range suggests that the direct costs associated with asbestos-related bankrupt companies total between \$325 million and \$650 million.

The pace at which these bankruptcies have been filed has accelerated in recent years: Since 1998, 35 companies have filed for bankruptcy protection because of asbestos-related claims, compared to 26 in the previous two decades. In the first ten months of 2002, 15 companies facing significant asbestos liabilities filed for bankruptcy – that represents more asbestos-related bankruptcies than in any five-year period before 1999.

This paper has focused primarily on the costs associated with firms declaring bankruptcy because of asbestos liabilities. While it is important to remember that such bankruptcies are unlikely to have substantial macroeconomic effects, it is also important to remember that the bankruptcies do not capture the full effect of asbestos liabilities on defendants. In particular, many other firms experience financial shocks as a result of asbestos liabilities even if they do not declare bankruptcy as a result. Furthermore, perhaps only a quarter of the estimated eventual costs associated with asbestos claims have been paid to date, raising the specter of many more companies facing severe financial effects and additional asbestos-related bankruptcies in the future. Any such additional bankruptcies are not reflected in our analysis.

Our conclusion is that the current system for handling asbestos claims imposes significant costs on the workers (and shareholders) of the defendant firms. Since many of these firms were not asbestos manufacturers, the costs imposed on workers may seem unfair and inefficient from an economic perspective.

I. Introduction

Prior to the 1970s, asbestos was an important and cost-effective input in a wide variety of manufactured products, from wire insulation to building materials. Asbestos had unique and attractive features: It was cheap, strong, flexible, and resistant to heat and decay. Reflecting these advantages, it was promulgated as a "strategic material" during World War II.[1] Throughout much of the 20th century, asbestos was widely used and an estimated 100 million Americans were occupationally exposed to it.[2]

In the early 1970s, the United States government – through the Occupational Safety and Health Administration (OSHA) within the Department of Labor – began regulating workplace exposure to asbestos. Over time, the regulations became increasingly stringent. Asbestos use remains technically legal in the United States today, but OSHA and Environmental Protection Agency (EPA) regulations have effectively phased out most uses of asbestos.

A number of diseases have been linked to asbestos exposure. The most severe is mesothelioma, a cancer that is fatal within one to two years of diagnosis. The inhalation of asbestos also can cause lung and other cancers. A third disease arising from exposure to asbestos dust is asbestosis, which is a fibrous scarring of the lung that may or may not impair an individual. A fourth condition associated with asbestos exposure is pleural plaques, which are generally non-impairing symptomatic changes in the pleural membrane covering the lung.

Prior to the 1970s, workers with an asbestos-related disease generally filed for relief through state worker's compensation systems. In 1973, the U.S. Court of Appeals for the Fifth Circuit ruled in *Borel v. Fibreboard* that manufacturers were liable if they failed to warn consumers about the risks associated with asbestos exposure.[3]

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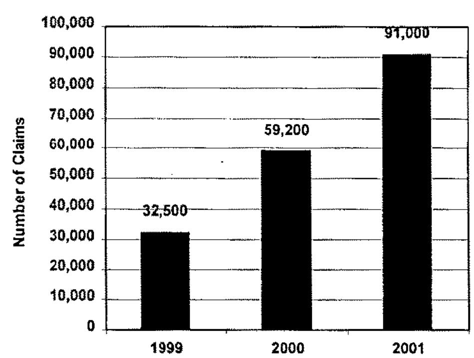
[1] See American Academy of Actuaries (2001), page 1.
[2] Ibid.
[3] See *Borel v. Fibreboard Corp.*, 493 F.2d 1076 (5th Cir. 1973). For a more detailed discussion of the history of asbestos litigation, see Castleman (1996).

Given the long latency period of asbestos-related diseases (up to 40 years), many experts had expected the filing of claims to peak in the 1980s or early 1990s.[4] Asbestos claims, however, continued to skyrocket in the 1990s.[5] A RAND Institute for Civil Justice (RAND) analysis of five major asbestos defendants suggests, for example, that each company was receiving roughly 15,000 to 20,000 claims per year in the early 1990s. By 2000, that number had increased to roughly 50,000 claims per year.[6] Similarly, the Manville Trust – which pays asbestos claims for former asbestos producer Johns-Manville – has experienced substantial increases in claims in the past few years. In 1999, the Manville Trust had 32,500 new claims filed against it. New claims rose to approximately 59,200 in 2000 and 91,000 in 2001.[7] (See Chart 1.)

Chart 1: Claims Filed Per Year Against the Manville Personal Injury Trust, 1999-2001



[4] Castleman, page 784.
[5] There are myriad reasons why the number of claims has increased so sharply. See White (2002), Plevin and Kalish (2001), and Prudential (2002) for a discussion of the reasons.
[6] Stephen Carroll et al. (2002), page 42.
[7] See http://www.mantrust.org

The claims are also increasingly being extended to a wider array of firms. In 1983, RAND found 300 firms had been listed as defendants in asbestos cases.[8] By 2002, RAND estimates that more than 6,000 independent entities have been named as asbestos-liability defendants.[9] The dramatic recent expansion in defendants raises an important public policy issue. One of the objectives of product liability law is to provide financial incentives for manufacturers to ensure the safety of their products. When joint and several liability is extended well beyond the original manufacturer to include an extremely broad class of firms, however, it could impose an inefficient burden.[10] As explained below, joint and several liability means that any firm in the production chain could potentially be held accountable for the entire cost of the damage associated with an input. To reduce the expected costs of such liabilities, the downstream firms may have to undertake excessive safety checks on all the inputs used in their production processes. The information costs associated with this activity may well outweigh the benefits associated with improved incentives for safety.

The incentive effects discussed above relate primarily to the expected cost of the liability facing specific firms. A distinct issue involves the distribution of any liability payments actually made to claimants. According to the RAND, at least 600,000 individuals filed asbestos-related claims between 1973 and the end of 2000, many against multiple companies.[11] This figure may be an underestimate of the total number of individuals filing claims since RAND's database is incomplete: it only has data on claims filed against certain companies, not every company with an asbestos claim against it. In addition, RAND notes that it only obtained data on claims submitted through the end of 2000; as shown above, however, a significant number of individuals filed claims in 2001.

[8] Stephen Carroll et al. (2002), page 49.
[9] Ibid.
[10] The long latency period involved in cases such as asbestos raises another potential impediment to the effectiveness of the liability system in providing incentives for the safety of products. If a firm's managers and owners will have departed by the time any safety problems or illnesses manifest themselves, the incentives provided for corrective action may be weakened.
[11] Stephen Carroll et al. (2002), page 40.

Nonetheless, other organizations have produced estimates that are similar to RAND's calculations.[12]

The dramatic acceleration in claims does not appear to be associated with an acceleration in the number of severely affected people... about 2,000 new mesothelioma cases are filed each year, a flow which is largely unchanged over the past decade

The dramatic acceleration in claims does *not* appear to be associated with an acceleration in the number of severely affected people. Indeed, the American Academy of Actuaries has concluded that about 2,000 new mesothelioma cases are filed each year, a flow which is largely unchanged over the past decade, and that the annual number of other cancer cases at least partly related to asbestos exposure amounts to between 2,000 and 3,000.[13] Such cases cannot come close to explaining the increase in asbestos claims being filed, which increased by almost 60,000 between 1999 and 2001.[14] RAND concluded that "it is clear that the growth in the annual number of claims observed...is entirely due to increases in the numbers of nonmalignant claims entering the system."[15]

The upshot is that the share of total new claimants who are unimpaired has increased sharply. In 1984, RAND estimated that fewer than four percent of claimants had no asbestos-related impairment.[16] A 1992 paper asserted that non-mesothelioma (and other cancer) claims "account[ed] for sixty to seventy percent of new asbestos claims filed."[17] In a 1993 paper, Professors Christopher Edley and Paul Weiler of Harvard Law School estimated that "up to one-half of asbestos claims are now being filed by people who have little or no physical impairment."[18]

More recent studies of have concluded that even a larger share of claimants is unimpaired. NERA, an economics consulting firm, found that roughly 75 percent of the

[12] For example, a 1999 National Judicial Conference report estimated that there were between 300,000 and 700,000 asbestos claimants.
[13] American Academy of Actuaries (2001), page 3.
[14] See www.mantrust.org
[15] Stephen Carroll et al. (2002), page 44.
[16] Kakalik et al. (1984), page 30.
[17] Brickman (1992).
[18] Edley and Weiler (1993).

claims brought against one defendant in 1999 and 2000 had no evidence of impairment.[19] Similarly, a preliminary analysis of claims filed against Babcock and Wilcox in 2001 concluded that "two-thirds of the claims... seek to recover for benign and harmless conditions such as pleural plaques, pleural thickening with no evidence of impaired lung function, or asbestosis with no evidence of impairment."[20] Data from claims against W.R. Grace produce similar results.[21]

The rapid increase in claims has, not surprisingly, been associated with an increase in total outlays. To date, RAND estimates that aggregate outlays for asbestos claims total $54 billion, with U.S. insurance companies covering an estimated $21.6 billion,[22] non-U.S. insurance companies covering $8 billion to $12 billion, and the defendant companies paying $20 billion to $24 billion, including at least five companies which have each spent more than $1 billion.[23]

Looking to the future, most analysts believe that the number of claimants and total outlays for claims will continue to rise. Tillinghast-Towers Perrin, an actuarial consulting firm, projects that 1.1 million claims will eventually be filed, with the total cost to defendants and insurers amounting to $200 billion.[24] Milliman USA, another actuarial consulting firm, also forecasts 1.1 million total cumulative claims, but it projects higher total costs ($275 billion).[25] These projections imply that only roughly half of the claims and one-fifth to one-quarter of the eventual costs have been paid to date.

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[19] See National Economic Research Associates, Unimpaired Claims Analysis (February 26, 2001). Of all claims received by the Manville Trust in 1999 and 2000, 11 percent were malignant claims (4 percent mesothelioma, 6 percent lung cancer, and 1 percent other cancers), and 89 percent were non-malignant claims.

[20] See Babcox and Wilcox's Report to the Court Regarding Asbestos Developments Generally and the Proofs of Claim Filed Here, at 32-37, and Road Map to Babcox and Wilcox's Defenses to Asbestos Personal Injury Claims, VII-1&2, *In re The Babcock & Wilcox Co.*, Bcy No. 00-10992 (Bankr. E.D. La)(October 18, 2001).

[21] See Debtors' Consolidated Reply in Support of Their Motion For Entry of Case Management Order, etc., In re W.R. Grace Co., Bcy No. 01-01139 (D. Del.)(November 9, 2001).

[22] See A.M Best (2001).

[23] Stephen Carroll et al. (2002), pages 53-55.

[24] Lehman (2002), page 5.

The staggering costs of asbestos liabilities have pushed many defendant companies into bankruptcy or to the brink thereof. We estimate that 61 companies have faced significant asbestos liabilities and have filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code as a result.[26] (Our selection methodology is described in more detail in the next section.)

The staggering costs of asbestos liabilities have pushed many defendant companies into bankruptcy or to the brink thereof

The pace at which these bankruptcies have been filed has accelerated in recent years: Since 1998, more companies have filed for bankruptcy protection (35 companies) than in the previous 20 years combined (26 companies). (See Chart 2.) In the first ten months of 2002, 15 companies facing significant asbestos liabilities filed for bankruptcy – that represents more asbestos-related bankruptcies in 10 months than in any five-year period before 1999.

Bankruptcy offers firms facing substantial asbestos liabilities a number of benefits.[27] First, bankruptcy includes an "automatic stay" on litigation in which the firm is the defendant. Second, the firm can often obtain an injunction, which temporarily protects the parent (as well as subsidiary firms that have not filed for bankruptcy) from asbestos liabilities. Since bankruptcy reorganization can often take more than five years, bankrupt firms often receive a relatively lengthy reprieve from paying asbestos liabilities. Moreover, as part of the reorganization plan, the bankrupt firm usually wins the right to pay claimants on much less favorable terms.

Another effect of a firm's declaring bankruptcy is that it may cause a "domino effect" on other asbestos-related defendants. The domino effect arises from three simple

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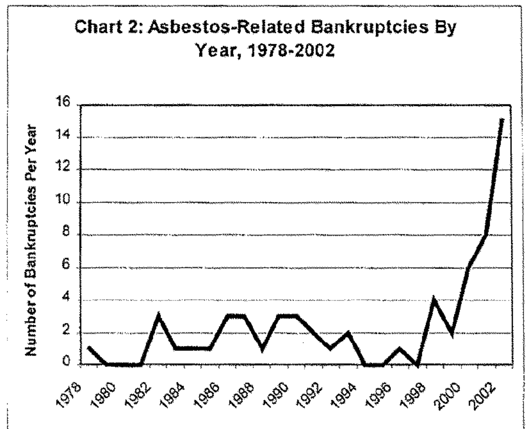
[25] Ibid, page 22.

[26] For comparison, RAND estimates in their September 2002 study that 60 companies have been pushed into bankruptcy due to asbestos liabilities. See Stephen Carroll et al. (2002), page 75.

[27] The *Economist* recently noted that, "Bankruptcy may not sound like an attractive option, but it is often the best alternative for firms in the throes of asbestos litigation." *The Economist*, September 19, 2002.

facts: (1) many states have joint and several liability for damage; (2) most people sue multiple defendants;[28] and (3) most claimants "forum shop."[29]



An example may help to explain how this effect works.[30] Suppose that an individual (John Doe) sues two companies (Company A and Company B) because he has developed asbestosis and is physically impaired. Further suppose that John Doe proves to a jury that both Company A and Company B are jointly liable for his impaired condition and they owe him a total of $500,000. If Company A goes bankrupt before it pays John Doe its share of the $500,000 (say, $250,000), Company B may be liable for Company A's share of the damages. Thus, if Company A files for bankruptcy, the asbestos-related costs for Company B increase. Such a structure creates a number of

[28] According to RAND, "In the early 1980s, claimants typically named about 20 different defendants. The data we have now suggests that by the mid-1990s, the typical claimant named 60 to 70 defendants." Stephen Carroll et al. (2002), page 41.

[29] A number of analysts have noted that a disproportionate percentage of the claims are filed in state courts that are considered to be "pro-plaintiff." For example, Mississippi has only one percent of the U.S. population, but accounts for roughly 20 percent of the pending claims. See American Academy of Actuaries (2001), page 3. *Fortune* magazine notes that in July 1999, "some 9,100 asbestos plaintiffs from all over the country were suing in rural Jefferson County, Miss.—about 700 more asbestos plaintiffs than there were county residents." See Parloff (2002). RAND has similarly found that five states account for two-thirds of recent cases filed, and 84 percent of all the claims were filed in just 10 states. See Stephen Carroll et al. (2002), pages 32 and 34.

[30] This example simplifies the joint and several liability rules, which vary across states.

perverse effects, including the incentive for firms to declare bankruptcy in order to shift liabilities to other firms (which in turn raises the probability that the other firms will be forced into bankruptcy) and the incentive for claimants to sue as many defendants as possible.

The events leading to the bankruptcy, along with the bankruptcy itself, also tend to be associated with a loss in human capital (for the workers displaced from their jobs) and organizational capital (if the firm is scaled back or no longer exists)

Although bankruptcy may provide benefits to firms facing significant asbestos liabilities, it also imposes economic costs. In particular, empirical studies have shown that bankruptcy is associated with significant transaction costs (for the lawyers, accountants, and others involved in the proceedings). The events leading to the bankruptcy, along with the bankruptcy event itself, also tend to be associated with a loss in human capital (for the workers displaced from their jobs) and organizational capital (if the firm is scaled back or no longer exists). As we discuss below, a significant share of these costs is borne by the firm's workers. In most cases, the workers would not have been in a position – nor perhaps even employed by the firm at the time – to alter the choice of input used in the production process. Having such workers bear a substantial share of the costs attenuates any positive incentive effects from the underlying product liability approach. In the absence of any significant incentive effects, the attractiveness of the product liability approach relative to alternatives for compensating victims is therefore weaker, since the product liability approach may involve higher transaction costs and be less fair than alternatives.

The purpose of this paper is to analyze the impact of asbestos-related bankruptcies on the workers of asbestos-related companies. The paper is divided into three sections. The first section explores the characteristics (such as size, location, and industry distribution) of the companies that have filed for bankruptcy due to asbestos-related claims. The second section focuses on the effects of asbestos liabilities on workers in the bankrupted firms, including the impact on employment levels and the effects on workers in their role as partial owners of the firm (especially through their pension plans). The final section draws conclusions from the previous sections.

II. Asbestos-Related Bankruptcies

This section provides a brief history of asbestos-related bankruptcies and examines the characteristics of the 61 bankrupt companies.[31] We compiled our list of bankrupt companies from five different sources: (1) a paper by Mark Plevin and Paul Kalish (*Where Are They Now? A History of the Companies That Have Sought Bankruptcy Protection Due to Asbestos Claims*), (2) the June 2002 Mealey's Asbestos Bankruptcy Report, (3) a March 2002 Lehman Brothers analysis (*Thinking About Asbestos*), (4) a December 2001 report of the American Academy of Actuaries (*Overview of Asbestos Issues and Trends*), and (5) a list of companies that have sought bankruptcy protection that was provided to us by the American Insurance Association. The entire universe of companies cited by these sources exceeded 70.

After compiling this list, three filters limited our sample to U.S. firms for which asbestos liabilities played a substantial role in causing the bankruptcy. First, we sought confirmation from a variety of contemporaneous sources (e.g., press releases, bankruptcy filings, newspaper stories, other regulatory filings, etc.) that asbestos liabilities played a *significant* role in the bankruptcy. To be sure, other factors may have contributed to the company filing for bankruptcy (e.g., foreign competition, financial mismanagement, etc.), but for the companies we designate as "asbestos-related bankruptcies," asbestos was identified as a significant contributing factor to the decision to enter into bankruptcy. Second, we excluded any non-U.S. corporations because of data limitations. Finally, to avoid double counting, we treated separate bankruptcies by subsidiaries of the same parent firm as one bankruptcy event. (For example, when UNR Industries filed for bankruptcy in 1982, ten related companies filed at the same time.)

A Brief History of Asbestos-Related Bankruptcies

Asbestos-related bankruptcies can be grouped into four waves. The "first wave" occurred between 1978 and 1985 when seven companies with significant asbestos liabilities filed for bankruptcy protection. For example, UNR Industries faced an estimated 17,000 asbestos claims and projected that it was going to face another 120,000 claims when it filed for bankruptcy in July 1982. Johns-Manville, still the largest employer to have declared bankruptcy because of asbestos claims, filed for bankruptcy the next month. The companies that comprised this "first wave" of bankruptcies were primarily large asbestos manufacturers.

The "second wave" of asbestos-related bankruptcies occurred between 1986 and 1993. During that time period, 18 companies entered into bankruptcy due to significant asbestos liabilities. Some of these companies were quite large: Todd Shipyards employed 4,400 workers in 1986, the year before it went bankrupt; and Hillsborough Holdings employed 8,935 workers in 1988, the year before it went bankrupt. None of these companies, however, approached the size of Johns-Manville, which employed 27,000 people in 1981.

From 1994 to 1997 ("the third wave"), there was a sharp downturn in asbestos-related bankruptcies. Only one company (Rock Wool Manufacturing) filed for Chapter 11 protection, although it was not a prominent asbestos-liability defendant.[32]

The "fourth wave" of asbestos-related bankruptcies started after the U.S. Supreme Court struck down *Georgine v. Amchem Products*, a landmark asbestos settlement, in June 1997. It accelerated after the U.S. Supreme Court overturned a 1993 global class action settlement, *Ortiz v. Fibreboard*, in June 1999. That settlement involved approximately 186,000 asbestos personal injury claims against the Fibreboard Corp., a

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[31] Three companies in the sample filed for bankruptcy after September 2002. Since our analytical work had been completed by then, we included these companies in the overall count, but did not include them in our various analyses.
[32] See Plevin and Kalish (2001).

maker of vinyl siding that is now a subsidiary of Owens Corning. As one Chief Executive Officer confided to *Fortune* in March 2002, "We should've filed bankruptcy on the day after the Georgine settlement was overturned by the Supreme Court... Every asbestos defendant should've done the same thing."[33] In 1998, there were four asbestos-related bankruptcies. By 2001, there were eight, and in the first ten months of 2002, there were 15 asbestos-related bankruptcies. These companies employed more than 135,000 workers: for example, Owens Corning employed 20,000 and Babcox and Wilcox employed 12,264 people in 1999, the year before both firms declared bankruptcy.

Size of Asbestos-Related Bankrupt Firms

Using data from Compustat, Dun & Bradstreet's Million Dollar Directory, Ward's Business Directory, Moody's, company web sites, and individual firms' Securities and Exchange Commission (SEC) filings, we constructed an employment database for the asbestos-related bankrupt companies. Employment data were available for only 40 of the companies. The other 18 companies were small and presumably excluded from the above-mentioned data sources; as noted above, three companies were excluded because they filed for bankruptcy after our analysis was completed. For some companies – roughly 10 – we built a time series of employment data between 1960 and 2001. For the other 30 companies, employment data were available on an infrequent basis or for shorter time periods (e.g., for Kaiser Aluminum, data were available for 1986 to 2001).[34]

Table 2 presents data on the size of the firms that have filed for bankruptcy in each of the four waves described above. Since 1978, 26 companies facing asbestos liabilities filed for bankruptcy when they had more than 1,000 employees, with seven companies having more than 10,000 workers when they filed for bankruptcy protection.

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[33] See Parloff (2002).

[34] Since employment data were often unavailable from the same data source for the whole time period, we often had to cross data series. Such a mixing of data series may introduce some biases in the employment numbers. If the data did not appear to match – that is, switching from one data source to another was associated with a significant increase or decrease in employment – we filtered the data from the database.

The companies that have filed bankruptcy most recently appear to be the largest firms, with six out of the seven largest filing for bankruptcy since 1998.

Table 2: Size of Asbestos-Related Bankrupt Companies, By Employment Level in Year Before Firm Entered into Bankruptcy, By Time Period

	"First Wave": 1978-1985	"Second Wave": 1986-1993	"Third Wave": 1994-1997	"Fourth Wave": 1998-2002	Total
More than 10,000 Employees	1	0	0	6	7
Between 1,000 and 10,000 Employees	1	8	0	10	**19**
Fewer than 1,000 Employees	0	5	1	8	**14**
Data Not Available	5	5	0	8	**18**
Total	7	**18**	**1**	**32***	**58***

* Three companies were excluded because they filed for bankruptcy after September 2002, when our analysis was completed.

Table 3 offers another perspective on the size of the bankrupted firms in the past four years. In total, the 40 companies in our database employed 204,868 workers the year before they filed for bankruptcy.[35] Two-thirds (66.7 percent) of these employees worked at firms that went bankrupt in the past four years. That is, the companies that went bankrupt between 1998 and 2002 employed a total of 136,831 people in the year before each company filed for Chapter 11 protection.

[35] For some companies data were unavailable for the year prior to it filing for bankruptcy. In such cases, we used the closest year data were available, as long as it was not more than five years from the date in which the company filed for bankruptcy.

Table 3: Number of Asbestos-Related Bankruptcies and the Number of Workers Employed By the Firms, By Time Period		
Time Period	Bankrupt Companies For Which We Have Employment Data	Number of Workers Employed By Bankrupt Firms Year Before Bankruptcy Filing
"First Wave": 1978-1985	2	30,600
"Second Wave": 1986-1993	13	37,365
"Third Wave": 1994-1997	1	72
"Fourth Wave": 1998-2002	24	136,831
Total	**40**	**204,868**

Another measure of the size of the bankrupt companies is their market capitalization one year prior to filing bankruptcy. From the Center for Research in Security Prices (CRSP) market database and individual companies' Securities and Exchange Commission (SEC) filings, we obtained market capitalization data for 17 companies. (Many of the bankrupt companies were either privately held or were subsidiaries of larger firms. For such companies, market capitalization data are not publicly available.) Since companies filed for bankruptcy in different years, we converted each firm's market capitalization level into July 2002 dollars using the Consumer Price Index (CPI-U). As Table 4 shows, four of the 17 firms had market capitalizations of more than $1 billion the year before they filed for bankruptcy, two firms had market capitalizations of between $500 million and $1 billion, six firms had market capitalizations of between $100 million and $500 million, and five firms had market capitalizations of less than $100 million. All four firms with market capitalizations over $1 billion filed for bankruptcy after 1998.

Table 4: Market Capitalization of Bankrupt Firms One Year Prior to Filing for Bankruptcy, in July 2002 Dollars	
Market Capitalization (in July 2002 Dollars)	Number of Firms
More than $1 billion	4
$500 million to $1 billion	2
$100 million to $500 million	6
Less than $100 million	5
Total	**17**

Industry Distribution of Asbestos-Related Bankrupt Firms

A number of analysts have noted that the companies facing asbestos liabilities are not concentrated in a particular industry. For example, RAND has found that "The firms on our current list of defendants fall into 75 different SIC categories at the 2-digit level. The SIC system divides the entire U. S. economy into 82 industries at this level. In other words, this litigation has spread to touch firms in industries engaged in almost every form of economic activity that takes place in the American economy."[36]

Companies outside asbestos manufacturing appear to be paying a larger share of the asbestos liabilities today. Specifically, according to a confidential study of asbestos costs cited by RAND, nontraditional defendants accounted for about 60 percent of asbestos expenditures by the late 1990s. By comparison, in the early 1980s, the report cites evidence that nontraditional defendants accounted for only about one-quarter of asbestos-liability costs.[37] A different analysis by Prudential Financial draws a similar conclusion. Prudential Financial notes that as traditional defendants – those involved in the mining, manufacturing, and distribution of products that included large amounts of asbestos – declared bankruptcy, claimants cited other organizations as responsible parties. The study notes, "Defendants are increasingly 'peripheral.' This generally means that: They did not manufacture, sell, or install asbestos-containing insulation or materials; [a]sbestos was more or less 'incidental' in their products or facilities; [i]f it was in their products, it was enclosed [and] therefore, only a minimal number of fibers were released into the air; and [t]heir current outstanding claims count is in the hundreds or low thousands… opposed to the more than one hundred thousand recorded by the traditional defendants."[38]

Companies outside asbestos manufacturing appear to be paying a larger share of the asbestos liabilities today

[36] See Stephen Carroll et al. (2002), page 50.
[37] Ibid.
[38] Prudential Financial (2002), page 3.

The Prudential Financial report provides a list of nearly 1,000 organizations that are current defendants in asbestos litigation, along with an industry classification for each defendant. As noted above, RAND estimates that there are more than 6,000 defendants. The Prudential Financial list is thus a subset of all defendants and only 39 bankrupt companies are included. We have divided this incomplete list into bankrupt and non-bankrupt companies. (See Table 5.) The table shows clearly that defendants – and, to a lesser degree, bankrupt companies – are spread across different industry groups.

Table 5: Distribution of Defendants and Bankrupt Companies, By Industry Group, As Presented in Prudential Financial's *Asbestos Litigation—A Problem Without A Solution*

Industry	Defendants	Bankrupt Companies
Aluminum & Metal Plants[39]	30	1
Asbestos Industry[40]	128	16
Automotive	5	
Brake Product Manufacturers	11	
Cement Manufacturer[41]	23	1
Chemical Plant	28	
Commercial Industry Jobsites	19	4
Commercial Industry West Coast	8	1
Construction	3	
Contractor	16	
Distributor	14	
Diversified	1	
Financial Services	3	
Fireproofing Manufacturers	6	2
Floor Tile Manufacturers	1	1
Food	1	
Gasket & Packing Manufacturers	1	
Hotels	2	
Imaging	1	
Industrial Boiler Companies	2	1
Lumber Industry Mills	3	
Lumber, Plywood, Veneer/Particleboard	24	
Manufacturing	47	2
Marine	3	
Media	1	
Mills – Plants	3	
Miscellaneous	1	
Oil Refinery	91	

[39] Includes defendants categorized as "Aluminum Plant."
[40] Includes defendants categorized as "Sold, Made, Designed Asbestos Products."
[41] Includes "Insulating Cement Manufacturer" and "Refractory Cement Manufacturer."

Paper/Pulp Mills	27	
Pharmaceuticals	3	
Power Plants[42]	230	
Real Estate	1	
Refineries/Chemical Plants	35	
Shipyards[43]	116	2
Steel Mill	58	1
Supplier	2	
Technology	1	
Telecommunications	3	
Thermal Insulation Manufacturers	7	3
Transite Pipe Manufacturers	4	1
Transportation	9	1
Turbine Companies	1	
Utility	2	
Wallboard, Plaster & Joint Compound Manufacturers	17	2
Total	992	39

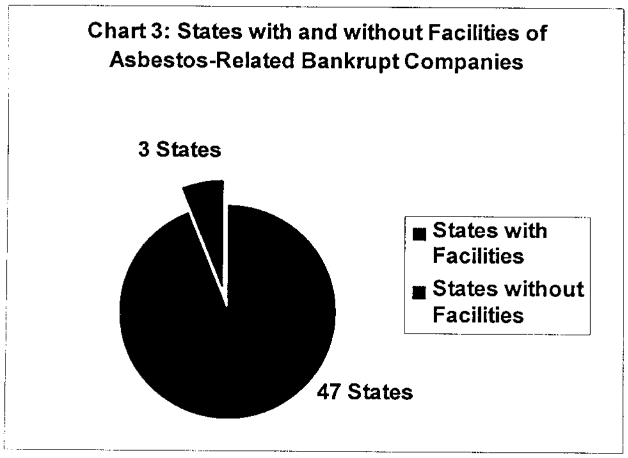
Location of Asbestos-Related Bankrupt Firms

Using the same sources described above to build our employment database, we also constructed a database on the locations within the United States of the companies that have sought bankruptcy protection due to asbestos liabilities. For 50 of the companies that have filed for bankruptcy before September 2002, we have data on the location of their headquarters. These companies are currently headquartered in 19 different states; Pennsylvania – which contains heavy concentrations of manufacturing firms -- accounts for almost a quarter of the bankrupted firms. See Table 6.

[42] Includes defendants categorized as "Industrial Sites – Power Plants," "West Coast Power Plant," "Power Plant," and "State & Electric Power Plants."
[43] Includes defendants categorized as "Shipyard."

Table 6: Distribution by State of Current Headquarters of Companies That Have Sought Bankruptcy Protection	
State	**Number of Companies Currently Headquartered in State**
Pennsylvania	12
Illinois	5
New Jersey	5
California	4
Maryland	3
New York	3
Alabama	2
Colorado	2
Florida	2
Michigan	2
Washington	2
Connecticut	1
Delaware	1
Idaho	1
Missouri	1
North Carolina	1
Ohio	1
Texas	1
Vermont	1

Our database also includes information on the location of company facilities. Many firms do not report the locations of all of their facilities, so this information is incomplete. In addition, our database does not include any information on the number of workers at a given facility. Despite these shortcomings, it is interesting that these 50 companies have facilities in 47 states. (See Chart 3.) The only states without a facility appear to be Hawaii, North Dakota, and Rhode Island.



Unionization of Asbestos-Related Bankrupt Firms

Although the bankrupt firms span a wide variety of industries, they are concentrated in manufacturing, which has a relatively high unionization rate. Many of the firms declaring bankruptcy report particularly high unionization rates in their SEC filings. For example, Johns-Manville reported that 42 percent of its workers were unionized in 1981, the year before it declared bankruptcy.[44] Other bankrupt firms report similarly high unionization rates for the year before they filed for bankruptcy: Eagle-Picher reported a unionization rate of 33 percent;[45] Federal Mogul reported 33 percent;[46] Armstrong reported 57 percent;[47] and Todd Shipyards reported 75 percent.[48]

[44] See Manville Corporation Annual Report (10-K) for the fiscal year ended December 31, 1981, page 11.
[45] According to Eagle-Picher, as of November 30, 1990, "approximately 33% of the Company's hourly employees were represented by eight labor organizations under 13 separate contracts." See Eagle-Picher Industries, Inc. Annual Report (10-K) for the fiscal year ended November 30, 1990, page 3.
[46] According to Federal Mogul, as of December 31, 2000, "Various unions represent[ed] approximately 33% of the Company's United States hourly employees." See Federal-Mogul Corporation Annual Report (10-K) for the fiscal year ended December 31, 2000, page 3.
[47] According to Armstrong, "About 57% of our approximately 12,400 hourly or salaried production and maintenance employees in the United States are represented by labor unions." See Armstrong World Industries Annual Report (10-K) for the fiscal year ended December 31, 1999, page 7.
[48] Todd Shipyards Annual Report (10-K) for the fiscal year ended March 30, 1986, page 9.

III. Economic Implications of Asbestos Liabilities and Bankruptcy

The previous section described the characteristics of the bankrupt companies that filed for bankruptcy prior to September 2002. This section explores the effect of asbestos-related liabilities and bankruptcies on employment, retirement security, government finances, and other economic factors. There is a large theoretical literature in economics, and a somewhat smaller empirical literature, on the effects of bankruptcies on firm financial policies and behavior.[49] Our focus here is more applied, and focuses specifically on asbestos-related bankruptcies.

Bankruptcies and the events that lead to them impose various forms of (potentially related) economic costs. First, the events leading to bankruptcy cause job displacement, which reduces the human capital of workers at the firm. These costs are borne primarily by the workers themselves (with some of the costs subsidized through the unemployment insurance system) but largely represent a loss to society as a whole. Second, bankruptcies can destroy the organizational capital associated with the firm; these costs are borne by both the workers and owners of the firm and also largely represent a loss to society as a whole. Third, the liability payments that caused the bankruptcy represent transfers from stockowners of the firm to victims; these transfers impose costs on the owners of the firm but produce benefits for the recipients. Only the net cost of the transfer – that is, any inefficiency associated with the transfer from one party to the other – represents a loss to society as a whole. Finally, the bankruptcy event itself involves direct transaction costs: the legal, accounting, and other costs associated with a bankruptcy can be significant. Our focus is primarily on the costs borne by workers at the bankrupt firms, through the loss of their human capital and the potential reduction in their retirement wealth (if they own shares of the firm through their retirement accounts), although we also discuss briefly the overall economic issues.

It is important to emphasize that some decline in the size, stock value, and employment of asbestos manufacturing firms is appropriate, given the discovery of the health risks associated with asbestos and the importance of the incentives provided by the liability system for improved safety. The purpose of this paper is not to separate the "appropriate" from the "inappropriate" costs associated with asbestos liabilities. Nonetheless, the mechanism used to transfer funds to victims is worthy of further examination. As discussed elsewhere in the paper, the increasingly extensive number of tangentially related defendants raises questions about the economic costs and benefits of the liability approach in this context.

Impact of Asbestos-Related Bankruptcy on Workers

As asbestos-related claims increase, firms may find it difficult to obtain new financing and retain clients. They may therefore seek to reduce costs, including labor costs, well before they actually declare bankruptcy.[50] In particular, as a firm approaches bankruptcy, it faces the challenge of maintaining its customer base and continuing production, which may make it difficult to maintain previous employment levels even before the bankruptcy occurs. Indeed, a common finding in the bankruptcy literature is that the threat of bankruptcy has real effects several years ahead of the bankruptcy event.[51]

The media have reported a large number of layoffs by firms declaring bankruptcy due to asbestos liabilities. For example, Federal-Mogul announced in January 2001 that it would close up to 50 of its 150 production units.[52] The following month (February 2001) it announced it was firing 1,100 workers.[53] This layoff followed an April 1998

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[49] See, for example, Stiglitz (1972).
[50] The forgone profits and investment opportunities associated with this reduction in firm-level activity before and during the bankruptcy form the primary component of the indirect costs associated with bankruptcy. As discussed in the text below, these indirect costs are in addition to the direct costs – for lawyers, accountants, and others – required in the bankruptcy event itself.
[51] See, for example, Altman (1984).
[52] Jamie Butters, "Credit Gives Big Supplier A Life: Federal-Mogul Says Added $550 Million Assures Its Survival," *Detroit Free Press*, January 4, 2001.
[53] See Federal-Mogul Press Release, "Federal-Mogul Adjusts Salaried Workforce Levels to Reflect Business Conditions," February 26, 2001.

announcement by Federal-Mogul of 4,200 job cuts.[54] In 1998 and 1999, the years before it filed for bankruptcy, Owens Corning reported 1,500 layoffs.[55] And U.S. Gypsum announced in January 2001 that it would eliminate 500 salaried jobs as part of a restructuring plan.[56]

We conducted a more systematic and rigorous analysis of employment among asbestos-related bankrupt companies. We have time-series employment data for 31 of the companies that filed for bankruptcy prior to September 2002. The 31 firms for which we have time-series employment data represent the vast majority, and likely roughly 90 percent, of total employment for the bankrupt firms as a whole.[57] For these firms, we compared the change in employment of each firm in the five years prior to bankruptcy to the change in employment for other firms in the same four-digit Standard Industrial Classification (SIC) code.[58] The five-year period was chosen as a rough proxy for the time between the first material revelation of asbestos liabilities and the bankruptcy event. A longer-time period, such as ten years, produces an even larger employment effect than the estimate presented below.

Data for each four-digit SIC code were obtained from the Bureau of Labor Statistics; for each four-digit SIC code, we obtained an estimate for employment at the non-bankrupt firms by subtracting the employment at companies that declared

[54] See Federal-Mogul Press Release, "Federal-Mogul Announces First Quarter Results and Special Charges Related to Acquisitions and Restructuring," April 23, 1998.
[55] See Owens Corning 2000 SEC 10-K filing.
[56] James Miller, "USG's Asbestos Woes Bring $904 Million Charge," *Chicago Tribune*, January 12, 2001.
[57] We have some employment data for 40 firms and a fuller set of time-series data for 31 firms. The sample of 31 firms represents roughly 91 percent of employment at the 40 firms as a whole one year prior to bankruptcy. The 18 firms for which we have no employment data are extremely small, and are extremely likely to have had less than a total of 10,000 employees. The 31 firms in our sample would then represent 87 percent of total employment for the bankrupt firms as a whole.
[58] For 11 of the 31 companies, we did not have employment data for the precise year the firm declared bankruptcy or five years prior to the bankruptcy filing. For example, eight of these 11 companies filed for bankruptcy in 2001 or 2002, but employment data were available only through 2000 or 2001. For such companies, we analyzed the 1995-2000 or 1996-2001 time periods. The SIC system has recently been replaced by the North American Industry Classification System (NAICS).

bankruptcy due to asbestos liabilities from the overall SIC employment level.[59] The results of this analysis are summarized in Table 7.

After adjusting for the changes in industry employment, the 31 firms lost 51,970 jobs in the five years prior to bankruptcy. (The raw change in employment – that is, the change without adjusting for employment changes at the industry level – was a loss of 60,636 jobs.) Nine firms showed gains in employment in the five years prior to bankruptcy, while 22 firms experienced declines in employment. The change in employment represents an average 22-percent decline – relative to changes in industry employment – for the 31 bankrupt companies. And, as the table shows, roughly half (53 percent) of the change in employment has occurred in firms that have filed for bankruptcy since January 1998.

The 31 firms for which we have data likely represented 87 percent of total employment at the bankrupted firms as a whole. Assuming that employment losses at the firms for which we lack data were proportionate to those for which we have data, the implied total employment loss for the bankrupted firms as a whole would be roughly 60,000.

Table 7: Change in Employment in Five Years Prior To Bankruptcy After Controlling for Changes in Industry Employment

	Number of Lost Jobs
Firms Filing for Bankruptcy Before January 1998	24,551
Firms Filing for Bankruptcy After January 1998	27,419
Total for Firms With Data	**51,970**
Estimated Scaled Total for All Bankrupt Firms	**~60,000**

[59] If employment data were unavailable for the four-digit SIC code, we used the three-digit SIC code. If data for the three-digit SIC code were unavailable, we used data for the two-digit SIC code. In cases in which the firm's employment level represented a significant portion (more than one-third) of the total employment in the industry code, we also used more disaggregated data.

This methodology effectively assumes that, in the absence of the bankruptcy, the bankrupted firm would have maintained a constant share of the industry's employment. An alternative methodology, which has been applied to revenue calculations in other bankruptcy studies, most notably Altman (1984), uses regression analysis to examine the relationship between the firm's employment and industry employment for some period before the bankruptcy. It then applies that relationship to industry employment immediately surrounding the firm's bankruptcy to obtain a predicted level of employment. The difference between the predicted level of employment for the firm and the actual level is then attributed to bankruptcy-related events. We also conducted this type of analysis. The overall results were not qualitatively different from those summarized above when the requisite data were available, although the results for individual firms did vary in some cases. Because of data limitations, we prefer the principal approach adopted above rather than this regression-based approach.

RAND has also estimated job losses associated with asbestos-related bankruptcies or liabilities. Specifically, it bases its calculations for changes in employment levels on the amount defendant firms have paid out ($23 billion). RAND estimates that a reduction of $23 billion in retained earnings would result in a reduction in investment levels by the defendant firms of up to $10 billion. RAND then estimates the employment effect of this reduced investment. The study concludes that, "If, on average, one less job is created each time a firm reduces its investment levels by $78,000, the number of jobs not created because asbestos defendants spent $10 billion less on investment up to the year 2000 would be approximately 128,000."[60] RAND notes that these figures represent upper-bound estimates, since non-defendant firms will likely "make up" for the reduction in investment by defendant firms. Note that we focus only on bankrupt companies; RAND examined all defendant firms regardless of whether they declared bankruptcy.

Regardless of the precise estimate attached to employment losses associated with asbestos, it is important to emphasize that the aggregate level of employment in the nation as a whole will be primarily determined by factors other than asbestos liabilities

[60] Stephen Carroll et al. (2002), page 74.

and the bankruptcies that have resulted. That is, while the firms that have declared bankruptcy due to asbestos liabilities have reduced employment by between 52,000 and 60,000, the effects on total employment are likely to be smaller.

The workers displaced from the bankrupted firms may ultimately find employment elsewhere, but the transition could be costly and lengthy

The workers displaced from the bankrupted firms may ultimately find employment elsewhere, but the transition could be costly and lengthy. For example, regional imbalances in employment may make it difficult for workers to find a new job that matches their existing skills within driving distance of their existing home. And it is costly for workers to move or learn new skills. Research by Henry Farber, an economist at Princeton University, has shown that "the costs of job loss are substantial. Employment probabilities are reduced substantially. There is an increased probability of working part-time, yielding lower earnings both through shorter hours and lower wage rates. These costs are larger for those workers with less education. And even those re-employed full-time suffer substantial earnings losses on average, regardless of education level."[61]

The economic costs resulting from the dislocation involve two components:

- First, the structural and frictional unemployment associated with the bankruptcies represents a lost opportunity. That is, to the extent that the movement of the displaced workers to new jobs produces a temporary increase in the unemployment rate that would not have otherwise occurred, the production of goods and services lost during the transition represents a true economic cost. Data from the Bureau of Labor Statistics suggest that the median displaced worker who had been previously employed for at least three years and who finds a new job went approximately six weeks between jobs.[62] Furthermore, only about four-fifths of displaced workers were re-employed within a few years of being

[61] Farber (2001), page 31.
[62] BLS (2001).

displaced.[63] To give a conservative estimate of the magnitude of costs involved, we can adopt a variety of simplifying, but nonetheless reasonable, assumptions. If we assume an average displacement lasts for one month, that the displaced workers had earned an average of $40,000 per year (which we also assume to be equal to the value of goods and services they produced), and that a total of 52,000 to 60,000 workers were displaced due to the asbestos-related bankruptcies, the unemployment spells associated with the displacements would represent an economic cost of about $175 million to $200 million.

- Second, displaced workers tend to earn lower wages at their new jobs, reflecting the loss of human capital associated with the displacement. Farber (2001) estimates that the loss in earnings from displacement amounts to between 5 and 10 percent of previous wages. Under the same assumptions as above, and assuming that the average displaced worker is 45, and has 20 years to retirement, the present value of the losses in wage income would amount to between $1.2 billion and $2.8 billion at a five percent real discount rate.

The total economic costs associated with the displacements under these assumptions would then amount to between $1.4 billion and $3.0 billion.

In addition to these earnings-related costs imposed on workers, bankruptcy also imposes costs on workers as shareholders. Many workers hold shares of the firm in their pension plans, so that workers suffer two forms of losses: a loss in their human capital (from their displaced employment) and a loss in their financial capital (from the decline in their retirement assets). In the next sub-section, we turn to estimates of the retirement asset losses experienced by workers in the bankrupt firms.

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[63] Helwig (2001).

Impact of Asbestos-Related Bankruptcy on Retirement Security

Layoffs may not be the only costs to workers from asbestos-related bankruptcies. Indeed, current (and former) workers may experience significant deteriorations in retirement savings if their pension account is invested in company stock. As Michael Kavanagh, the president of a local union that represents 400 W.R. Grace employees in Baltimore, recently told the *Baltimore Sun*, he is "worried about retirees and those about to retire who were counting on the Grace stock they'd built up over the years to help supplement their post-paycheck years."[64]

This concern arises because as asbestos liabilities increase, the market value of the firm usually declines. Such stock market declines manifest themselves in decreased values of employee defined contribution (DC) pension plans, such as 401(k)s. In 1998, 40 percent of families had a 401(k) or other similar DC pension plan through their employer.[65] And as various policy-makers have emphasized in recent months, a significant portion of these DC pension plans are invested in the company's stock: According to the Employee Benefit Research Institute, roughly one-fifth (19 percent) of 401(k) assets are in company stock.[66] In total, the National Center for Employee Ownership estimates that approximately 25 to 30 million U.S. employees own stock in their companies through employee stock ownership plans (ESOPs), broad-based stock option plans, and DC plans.[67]

To estimate the impact of asbestos-related bankruptcies on employee retirement assets, we undertook two different approaches.

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[64] Kristine Henry, "Old W.R. Grace v. New," *The Baltimore Sun*, July 1, 2001.
[65] Sunden and Surette (2000), Table 1, Page 2.
[66] Dallas Salisbury, Testimony Before the Senate Committee on Health, Education, Labor, and Pensions, February 7, 2002. Also see Munnell and Sunden (2002).
[67] See www.nceo.org

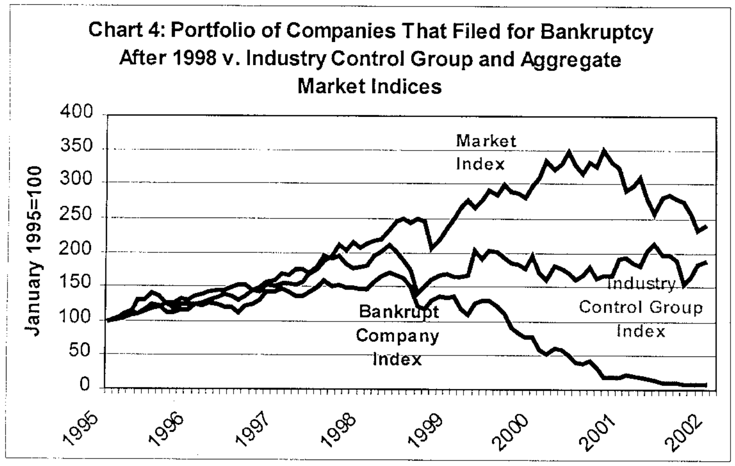
<u>Changes in Stock Prices</u>

The first method uses an estimate of the change in the stock price due to asbestos liabilities to calculate the change in retirement assets for each worker.

Of the companies that went bankrupt due to asbestos liabilities prior to September 2002, we have consistent time-series stock market data for 13 of them. As with the analyses of changes in employment, we compare stock market performance to a control group. In particular, we track the stock market price of each company for the five years before and, if possible, five years after bankruptcy to the performance of a control group of companies, weighted by market capitalization, that produce similar products and face similar economic and market circumstances. (Control group companies are those in the same three-digit SIC code as the bankrupt company, but have not filed for Chapter 11 protection for asbestos-related reasons.) Data on stock prices were obtained from the CRSP database; stock price data were adjusted to take into account dividend payments.

We limit the analysis to a ten-year period that begins five years prior to Chapter 11 filing and extends up to five years after the filing; the comparison stops before five years if the company liquidated, was acquired, or if the bankruptcy took place within the last five years. As before, we compare a market capitalization index for each bankrupt firm to a value-weighted market capitalization index for a control group of companies drawn from the same SIC. The index is normalized to 100 in January 1995 – the first period of comparison.

The results of this exercise for firms declaring bankruptcy after 1997 are shown in Chart 4. To simplify the presentation, aggregate indexes of the bankrupt firms and non-bankrupt firms within the same industries were constructed. As the graph shows, the bankrupt firms experienced significant stock market declines relative to their industry groups: while the industry control group increased 87 percent between 1995 and 2002, the bankrupt firm index fell 92 percent.



An analysis of the firm-by-firm results for all 13 companies for which we have full data shows that *all* these bankrupt firms underperform relative to their industry control group. This type of stock market underperformance is perhaps not surprising and has been found in other broader studies of bankruptcies.[68] The next step involves converting these results into an estimate of the impact on pension assets. Of the 13 companies analyzed, six report information on what share of employee pension assets are invested in common stock. We used information from the firm's SEC filings to estimate the per plan participant assets held in company stock.[69] Among the six firms, the average plan participant had 401(k) assets of $35,891, with $9,098 invested in company stock five

[68] See, for example, Altman (1984).

[69] We obtained SEC filings for 16 of the bankrupt companies. We first excluded three companies with ownership changes. Of the remaining 13 companies, eight reported defined contribution plans. Two of these companies were excluded because data were not available for the period within two years of bankruptcy. Of the remaining six companies, we computed the net common stock fund value per plan participant. In cases in which the companies offered multiple plans to various classes of employees, we consolidated the funds and participant figures. For one company (Federal Mogul), data on the number of plan participants were unavailable; we assumed that two-thirds of the employees were participants in the DC plan. Where a common stock fund's asset and liability breakdowns were not given, we used the fair market value of the common stocks held by the plan. For two companies, we were unable to obtain data for five years prior to bankruptcy. For both companies (Federal Mogul and Eagle Picher), we used data from three years prior to bankruptcy.

years before the company filed for bankruptcy.[70] Common stock thus represented 25 percent of the pension assets five years before the firms filed for bankruptcy; by comparison – as noted above – the national average is 19 percent.

If the investment in company stock had followed the industry control group index for these firms, the employee's pension assets would have dropped from $9,098 to $8,662. Instead, they declined by 96 percent. That is, on average, instead of the value of company stock falling to $8,662, it fell to $401 – a loss of $8,261 in pension wealth per affected worker relative to the level that would have obtained if the stock performed in line with the rest of the relevant industry control group. The total defined contribution pension losses amounted to more than $350 million.

Changes in Per Plan Participant Assets

The second methodology utilizes information supplied to the SEC by the companies in annual filings. Specifically, in 11-K filings, publicly traded companies report the share of the firm's pension fund assets that are held in company stock. We can thus calculate the assets that each plan participant holds in company stock by dividing that amount by the total number of plan participants.

We examine the per plan participant assets invested in company stock for five years before (or the closest time period to five years before) the company filed for bankruptcy and for the year the company filed for bankruptcy.[71]

This approach does not directly rely on an estimated change in the stock price, as the first approach does. But like the first approach, it implicitly assumes that the decline in plan assets is due to the bankruptcy itself rather than other factors. In addition, this approach has three shortcomings not relevant to the first approach. First, it likely obscures the underlying trend in per plan participant assets, since participants continue to contribute to the pension plan in the intervening period. Second, it does not control for

[70] These figures represent the average of the six firms, weighted by the number of plan participants.

changes at the industry level. In other words, it does not make even a crude adjustment for the change in per plan participant assets that would have occurred in the absence of the asbestos liabilities (e.g., the industry may have suffered a severe downturn that would have affected the per plan participant assets regardless of the asbestos liabilities). Finally, the per plan participant metric can be affected by hiring decisions and pension participation rates, since the addition of new plan participants with below-average balances would cause a decline in the per plan participant measure.

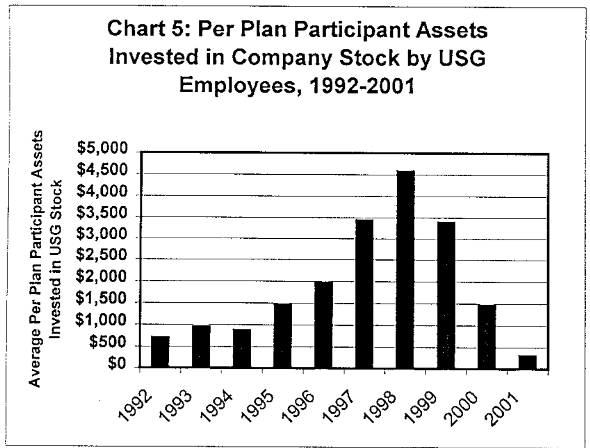
As noted above, we have data on pension fund investments in company stock for six firms. As Table 8 indicates, the weighted average per plan participant assets in the six companies for which we have data fell by $8,307 from the five years prior to bankruptcy to the year of bankruptcy.

Table 8: Change in Average Per Plan Participant Assets in Company Stock for Six Asbestos-Related Bankrupt Firms

	Average Per Plan Participant Assets
Five Years Before Bankruptcy	$9,098
Year of Bankruptcy	$791
Change	**$8,307**

As one example, Chart 5 shows the change in the per plan participant assets invested in company stock for USG employees. Between December 1996 and December 2001, per plan participant assets fell by $1,670, from $1,976 in December 1996 to $305 in December 2001. In December 1996, the pension fund held nearly $20 million in company stock; by December 2001, it held just $3.7 million. After accounting for inflows of pension savings, the USG pension fund lost more than $40 million between December 1998 and December 2001 due to the drop in USG's stock.

[71] For two of the six companies, data were only available for three years before bankruptcy.



Changes in Retirement Security

We can apply the results from the two methodologies above to estimate the impact on workers (and their families) from the loss of pension wealth. Such a reduction in pension wealth imposes a cost that could manifest itself in one of three ways: a reduction in consumption during retirement; an increase in savings (and thus a decrease in consumption) before retirement; or a delay in retirement.[72] To provide insight into the potential magnitude of these adjustments, we built a model of retirement saving.

The model takes a given level of current pension wealth, projects it forward to an assumed retirement age, and then annuitizes it (that is, converts the accumulated pension account into a monthly payment that is paid as long as the annuitant or his or her spouse is alive). The model takes into account the current age of the worker, the marital status of the worker, the worker's marginal tax rate in retirement (to examine after-tax retirement income), the worker's current 401(k) balance; the worker's current earnings; the worker's anticipated retirement age; an assumed real return on the 401(k) assets; an

[72] It could also manifest itself as a reduction in the worker's bequests to his or her children. For simplicity, we ignore this possibility.

assumed rate of aggregate real wage growth, combined with the age-wage profile constructed by the Office of the Chief Actuary at the Social Security Administration; and marital-specific annuitization rates. By comparing the results before and after the decline in pension wealth, the model can then be used to examine the effects of the decline on after-tax retirement income if no changes are made to saving or the worker's retirement age; required saving prior to retirement to maintain the previous level of after-tax retirement income; and the delay in the retirement age necessary to maintain a given level of after-tax retirement income without an increase in saving.

The projections shown in the table below assume actuarially fair annuities; a 5 percent real pre-tax return on assets; 1.5 percent aggregate real wage growth; a 25 percent marginal tax rate in retirement; that the worker is currently earning an age-adjusted lifetime equivalent of $45,000 per year; that the worker is married; and the worker intends to retire at age 65. We examine three workers: a 35-year-old, 45-year-old, and 55-year-old. Unfortunately, we do not have data on plan assets by age of worker. Therefore, for each worker, we assume 401(k) balances were initially equal to mean per plan assets for the affected companies ($35,891) multiplied by an age-related scaling factor. The age-related scaling factor was derived by comparing median financial assets by age groups from the Federal Reserve's Survey of Consumer Finances, and assuming that the median worker was 45 years old. The result was an assumed initial 401(k) balance of $14,795 for the 35-year-old worker; $35,891 for the 45-year-old worker; and $43,898 for the 55-year-old worker. In each case, we assumed a decline due to the bankruptcy of 25 percent, which is roughly consistent with the observed declines in plan assets (as discussed above).

As Table 9 shows, the losses imposed by bankruptcy cause substantial, albeit perhaps not devastating, costs on workers. For example, if a 45-year-old worker lost 25 percent of his assumed 401(k) balance, he could either allow his retirement income to fall by $1,250 per year or he could raise his annual 401(k) saving before retirement by $720 per year. For older workers, several offsetting forces affect the results. The first factor is that the accumulated 401(k) balances prior to the decline are assumed to be larger for the

55-year-old than for the 45-year-old, meaning that a given percentage decline represents a larger absolute loss at the time for the older worker. On the other hand, the power of compound interest means that a loss of $1 to a 45-year-old corresponds to a larger loss in retirement income than the loss of $1 to a 55-year-old. For example, $1 today would accumulate to $2.65 over the twenty years that a 45-year-old has until retirement; $1 today would accumulate only to $1.63 over the ten years that a 55-year-old has until retirement. Therefore, although the 55-year-old may lose more dollars today, the 45-year-old suffers more from the lost power of compound interest. Finally, the 55-year-old has fewer working years over which to make up the loss through additional contributions to the 401(k) plan.

Table 9: Impact of Loss of Pension Wealth on Measures of Retirement Security

	35-year old worker	45-year old worker	55-year old worker
	Assuming 25 percent decline in 401(k)		
Increase in required 401(k) saving per year to maintain pre-reduction retirement income ($2002)	$241	$720	$1,421
Reduction in retirement assets ($2002)	$15,986	$23,807	$17,876
Reduction in annual after-tax retirement income ($2002)	$839	$1,250	$939
Delay in retirement age to maintain pre-reduction retirement income per year (years)	0.48	0.83	0.72

Note: See text for assumptions.

Other Pension Losses Due to Asbestos-Related Bankruptcies

Bankruptcies can also impose large costs on defined benefit (DB) pension plans in addition to defined contribution plans. The Federal Government plays a significant role in protecting employees and retirees who participate in traditional (defined benefit) pension plans. A key element of that protection is the benefit guarantee for underfunded, terminating defined benefit plans that is administered by the Pension Benefit Guaranty

Corporation (PBGC), a government corporation established within the Department of Labor.[73] (Since the PBGC is required to be self-financing, it does not impose any direct cost on the Federal Government or on the taxpayers when it assumes trusteeship of a particular plan and thereby takes on additional liabilities to pay claims.) One example of a defined benefit plan that the government "took over" was the Atlas Corporation's 1978 Retirement Plan, which covered 148 workers. Atlas filed for bankruptcy in September 1998. On October 27, 1999, Atlas' DB plan was terminated and the PBBC became the trustee on November 18, 1999.[74] PBGC also took action against Raymark Industries. (Raymark created Raytech Corporation, which filed for bankruptcy in 1989.) In 1999, PBGC won a decision against Raymark. In the case, PBGC sought to ensure that Raymark covered the $19 million in pension liabilities owed to 1,500 former workers based in Connecticut, Pennsylvania, Indiana, South Carolina, and North Carolina.[75]

Losses associated with the declines in firm values (embodied in both stock value drops and corporate debt restructurings) are not, of course, concentrated solely among the employees and pension plans of the bankrupted firm. Instead, all shareholders and creditors bear some of the burden. For example, soon after USG Corporation entered into bankruptcy, the New York State Teachers Retirement Board ranked as the twelfth largest institutional investor in USG Corporation with nearly 400,000 shares.[76] The California Public Employees Retirement System (CALPERS) is currently the eighth largest institutional investor in W.R. Grace, which filed for bankruptcy in April of 2001.[77] And CALPERS and TIAA-CREF are two of the top ten institutional investors in Kaiser Aluminum.[78]

The sharp declines in the stock market value of asbestos-related bankrupt companies would thus likely have broader effects. One example of such a loss is the

[73] See, for example, Title IV of the Employee Retirement Income Security Act of 1974, as amended (ERISA), 29 USC section 1301 et seq.
[74] See http://www.pbgc.gov/plans/Planlookup.cfm?plan=2814
[75] See http://www.pbgc.gov/news/press_releases/1999/pr00010.htm
[76] In December 2001, the New York State Teachers Retirement Board owned 0.91 percent of USG Corporation. See http://www.marketguide.com
[77] See http://biz.yahoo.com/hd/g/gra.html
[78] See http://biz.yahoo.com/hd/k/klucq.ob.html

New York State Teachers Retirement Board's experience with Owens Corning. On March 31, 1999, the Board owned 449,200 shares of Owens Corning. While these shares represented a very small share – roughly 0.03 percent – of the entire pension fund, the value of the stock declined by roughly one third between March 31, 1999 and September 30, 1999. Owens Corning stock price continued to slide as it approached bankruptcy: It fell from 21.69 on September 30, 1999 to 1.19 on October 20, 2000 – a 95 percent decline in 13 months. If the New York Teachers Retirement Board had not sold any shares before Owens Corning filed for bankruptcy in October 2000, the pension fund would have lost nearly $14 million.

It is possible that the stock prices for other, non-defendant firms are indirectly bolstered by the asbestos liabilities – for example, successful claimants likely spend at least part of their awards on something, and the firms selling those goods and services could experience increases in their stock prices. But any such effects are almost impossible to quantify precisely – and given the transaction costs associated with the process, the overall effect on share values is very likely to be negative.

The Direct Costs of Asbestos-Related Bankruptcies

The estimates above are proxies for what are called the "indirect costs" of bankruptcy (Altman 1984). But the bankruptcy event itself involves direct transaction costs: the legal, accounting, and other costs associated with a bankruptcy can be significant.

Altman (1984) finds that the direct bankruptcy costs amount to 6.2 percent of a firm's value during the year of bankruptcy. RAND cites evidence that the cost of bankruptcy reorganization is equal to about three percent of a firm's value, based on Franks and Touros (1989); Weiss (1990); and White (1996). The RAND figure, however, values the firm's debt at book value rather than market value; Altman, where possible, uses market value instead.

To date, no one has studied the direct costs of asbestos bankruptcy reorganization. The bankruptcies that have been studied in the literature involved large publicly traded corporations comparable in size to large asbestos defendant corporations. But reorganization costs for asbestos defendants may be higher than figures reported in these earlier studies because none of the studied bankruptcies included massive numbers of tort creditors.

Based on the earlier literature, a conservative estimate is that the direct costs of bankruptcy amount to between 3 and 6 percent of the firm's market capitalization. Since the aggregate market capitalization one year prior to bankruptcy (in July 2002 dollars) for the 12 companies for which we have data was $7.2 billion, the direct costs associated with these asbestos-related bankrupt companies will total between $225 million and $425 million. These 12 firms represented about two-thirds of employment at the bankrupted firms as a whole; if the ratio of market capitalization to employment were the same for the other bankrupted firms as for these 12 firms, the total direct costs would amount to between $325 million and $650 million.

The previous studies had included some measure of corporate debt in computing the relative direct costs of bankruptcy; by excluding the debt altogether while nonetheless adopting the range of relative cost estimates from the previous studies, we obtain a conservative estimate for the dollar value of the direct costs. If we include the book value of the debt (nearly $12 billion) for the 12 companies for which we have data, the direct costs would range from $575 million to $1.1 billion. If we assume that the debt-worker ratio were the same at the firms for which we lack financial data, the total direct costs would amount to between $850 million and $1.7 billion.

Impact of Asbestos-Related Bankruptcy on Government Finances

The layoffs and stock market price declines associated with asbestos liabilities may have a variety of effects on government finances. For example, workers laid off from the firms facing asbestos claims may qualify for unemployment insurance and retraining programs. They may also become eligible for other means-tested benefits (including Food Stamps and Medicaid), depending on their family status, assets, and income while unemployed. In addition, the loss in wage income among the laid-off workers reduces both payroll taxes and income taxes, and the decline in stock prices for the bankrupted firms reduces capital gains if the stocks are held in taxable accounts (and ultimately reduces income taxes if the stocks are held in traditional retirement accounts). The loss in corporate profits at the firms involved reduces corporate profits tax revenue. But just as the employment losses at the affected firms will eventually be balanced by employment gains elsewhere in the economy as employment shifts to new jobs, the aggregate effect on government expenditures and revenue is less deleterious than this partial equilibrium picture may suggest.

Costs Imposed on Firms That Do Not Declare Bankruptcy

This section has focused primarily on the costs associated with firms declaring bankruptcy because of asbestos liabilities. While it is important to remember that such bankruptcies are unlikely to have substantial macroeconomic effects, it is also important to remember that the bankruptcies do not capture the full effect of asbestos liabilities on defendants to date, nor do they reflect the future costs imposed from ongoing litigation. As noted above, roughly a quarter of estimated total costs to defendants and insurers have been paid to date.

The companies facing significant asbestos liabilities and that have not declared bankruptcy are spread throughout the economy, representing nearly every industry group.[79] Among the companies facing such claims are a major paper and forest products company, a major media conglomerate, and leading transportation firms. For example, the major media conglomerate reported 118,000 asbestos claims outstanding against it as of June 30, 2002 – and during the second quarter of 2002 alone, it received 9,700 new claims. One major industrial firm, which never produced or sold asbestos, faces as many as 74,700 claims because its "dust masks" did not adequately protect against asbestos.

As *Fortune* magazine recently noted, "The filings by workers in so-called nontraditional industries -- industries in which employees seldom come anywhere near asbestos dust -- have skyrocketed. Filings in the textile industry, for instance, jumped more than 721% in the past two years, according to one defendant's records; in the pulp and paper industries, 296%; in the food and beverage industries, 284%. Companies like Chiquita Brands, General Electric, and Sears Roebuck have all been hit with asbestos suits."[80]

The uncertainty surrounding such claims raises borrowing costs and reduces equity values for the firms, thereby impeding their activities. It may also discourage firms from merging, even when such mergers would make economic sense. We have not attempted to quantify the economic effects of asbestos claims against firms that have not (or not yet) declared bankruptcy.

IV. Conclusions

A large component of the payments made to asbestos claimants involves transfers from workers at the defendant firms. The pain and suffering of the impaired claimants is palpable; the costs imposed on the workers in the defendant firms is often less clear. The purpose of this paper is not to suggest that impaired claimants are unworthy of assistance, but rather to highlight the fact that payments to any claimants are not free. They impose significant costs on the workers and shareholders of the defendant firms. Since many of these firms were not asbestos manufacturers, the costs imposed on workers may seem unfair and inefficient from an economic perspective.

As we describe above, bankruptcies associated with asbestos liabilities have had a marked deleterious effect on workers in those firms. Employment declines at these firms have amounted to between 52,000 and 60,000 jobs. The displaced workers typically

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[79] See Stephen Carroll et al. (2002).

[80] See Parloff (2002).

suffer periods of unemployment before finding a new job, and then often must accept a reduction in wages in order to become re-employed. The costs imposed on these displaced workers amount to between $1.4 billion and $3.0 billion in present value, or roughly $25,000 to $50,000 per displaced worker.

These costs are not the only ones imposed on workers at the bankrupted firms. For example, workers at many firms are also shareholders in the firm, since they hold company stock in their defined contribution pensions. The average worker at a bankrupted firm with a 401(k) plan suffered roughly $8,300 in losses. For a 45-year-old worker with an average 401(k) balance, such a loss would mean his retirement income would fall by $1,250 per year. To prevent such a decline, he would have to raise his annual 401(k) saving before retirement by $720 per year.

In light of these costs, re-examining the system used to compensate those with illnesses associated with asbestos exposure seems worthwhile. In the context of asbestos, the beneficial incentive effects often associated with a product liability system are attenuated because claims are increasingly being extended to a wider array of firms. The liability approach also involves significant transaction costs. Finally, the liability approach raises basic questions of fairness. Citizens who have suffered from asbestos-related illnesses deserve appropriate compensation. The crucial issue, however, is how we as a society decide to meet those costs.[81] The current system does not appear to an optimal mechanism for doing so.

[81] Supreme Court Justice David Souter wrote that "The elephantine mass of asbestos cases... defies customary judicial administration and calls for national legislation." See *Ortiz et al. v. Fibreboard Corp et al.*, Docket 97-1704, (decided June 23, 1999). Similarly, Senator Patrick Leahy, the Chairman of the Senate Judiciary Committee, recently stated that "Congress can provide a secure, fair, and efficient means of compensating victims." See Senator Patrick Leahy, Statement before the Senate Judiciary Committee, September 25, 2002.

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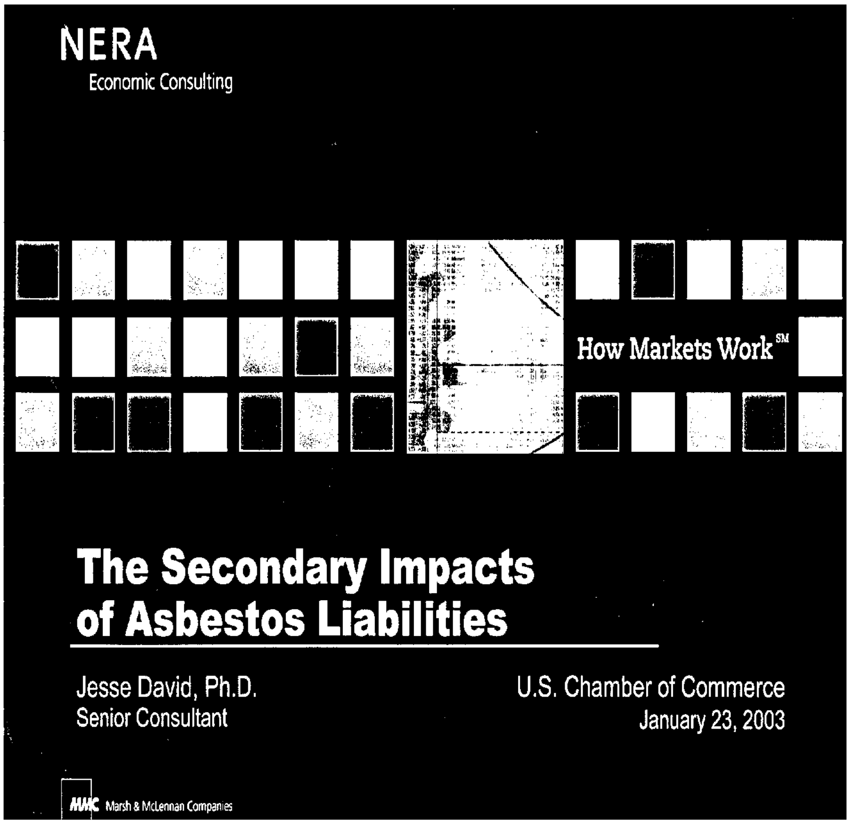

NERA
Economic Consulting
How Markets Work℠
The Secondary Impacts of Asbestos Liabilities
Jesse David, Ph.D.
Senior Consultant
U.S. Chamber of Commerce
January 23, 2003
MMC Marsh & McLennan Companies

The Economic Impacts of Asbestos Liabilities: The Ripple Effect

Primary Effects
(Sebago)

Additional Impacts on
Workers at Bankrupt Firms

Impacts on Local Communities

Impacts on Taxpayers

Characteristics of A Displaced Worker From Firms Facing Asbestos Liabilities

- Between 52,000 and 60,000 jobs have been lost due to asbestos-related bankruptcies *to date* (Sebago, 2002)
- About 90% of the bankrupt firms are in Non-durables Manufacturing
- A large portion of these firms had facilities in small communities
  - **Average population: 138,000**
  - **Median population: less than 25,000**

Characteristics of A Displaced Worker From Firms Facing Asbestos Liabilities

Continued...

- The typical displaced worker is:
  - Blue collar trade
  - High school graduate
  - 6 to 7 years of tenure at lost job
  - Earnings of about $506 per week in lost job
- Employment status after 2 to 3 years:
  - 11% remain unemployed
  - 14% have dropped out of the labor force
  - Those re-employed:
    - Are unemployed for about 10 weeks
    - However, 22 to 25% are unemployed for more than 6 months
    - Earned 3 to 17% less in new job even after 2 to 3 years

Additional Costs Borne by Displaced Workers: Retraining

- 42% of displaced manufacturing workers participate in training programs
- Retraining programs cost about $2,000 to $3,000 per worker
- Total cost to date: $44-76 million
- Costs are shared by:
  - Workers
  - Companies
  - Federal/state governments

Additional Costs Borne by Displaced Workers: Loss of Group Healthcare

- Cost of health care for family of four:
  - Monthly cost under group plan: $162 per month
  - Monthly cost under individual plan: $464 per month

Individual plans cost $302 *more* per month

- Individual health plan costs more than 50% of unemployment benefits
- Total *monetary* costs to date:
  - about $30 million
- What about families without insurance?

Impact of Unemployment Insurance

- Average national UI benefit: $200 per worker per week
  - Average duration of UI benefit: 14.6 weeks
  - But only 49% of displaced workers from manufacturing industries receive unemployment insurance.
- Only a partial offset to lost wages
  - Less than 50% of weekly earnings in lost job

Total cost to taxpayers of UI benefits to displaced workers from asbestos-related bankruptcies: approximately $80 million

Costs Borne by Local Communities: Reduced Income for Local Businesses

- Local business lose through indirect impacts of plant closures and the "multiplier effect"
- Regional impact models provide estimates:
  - **REMI: a "state of the art" model that predicts local impacts over time**
  - **Estimates the local economic impacts from each job lost due to asbestos liabilities**
  - **The magnitude of the effect will depend on the characteristics of the local community**
- Average effect: Eventually about 8 *additional* jobs lost locally for every 10 initial jobs lost

Costs Borne by Local Communities: Reduced Income for Local Businesses

Continued...

Example: In 2000, Owens-Corning laid off 275 workers from its Granville plant in Licking County, Ohio

- REMI model predicts:
  - Indirect/induced impacts
    - 77 jobs lost in local Services
    - 60 jobs lost in local Retail Trade
    - 48 jobs lost in local Construction
  - Total lost employment in the county: approximately 500 jobs
  - Total output reduced by over $60 million annually
  - Approximately 1 out of every 2 displaced workers will relocate out of the county
  - Total reduction in regional income: about $15-20 million annually

Costs Borne by Local Communities: Reduced Income for Local Businesses

Continued...

- In summary, the effect of local reductions in income are magnified by the "multiplier effect"
- Total effect nationwide: to date, $0.6-2.1 billion in local costs *additional* to those reported by Sebago due to indirect and "multiplier" impacts
- These represent only the *net* costs—impacts on the affected communities will be much higher

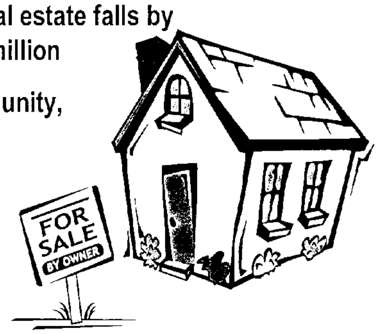
Costs Borne by Local Communities: Falling Real Estate Values

- Plant closures or mass layoffs will affect all owners of local real estate
- Research has shown that property values are dependent on local incomes and population
  - Income effect: ~ 0.2
  - Population effect: ~ 1.1

Costs Borne by Local Communities: Falling Real Estate Values

Continued...

- Example: Licking County, Ohio—500 lost jobs
  - Population/per-capita income each decline by 0.1%
  - Total value of local real estate falls by approximately $5-10 million
  - The smaller the community, the larger the effect



Costs Borne by Local Communities: Local Sales and Property Taxes

- Depends on local tax structure
  - Property tax collections affected by falling real estate values
  - Some offset due to reduced local expenditures
  - Sales tax receipts affected by declining local output
- Federal and state taxes also impacted by temporary decline in income

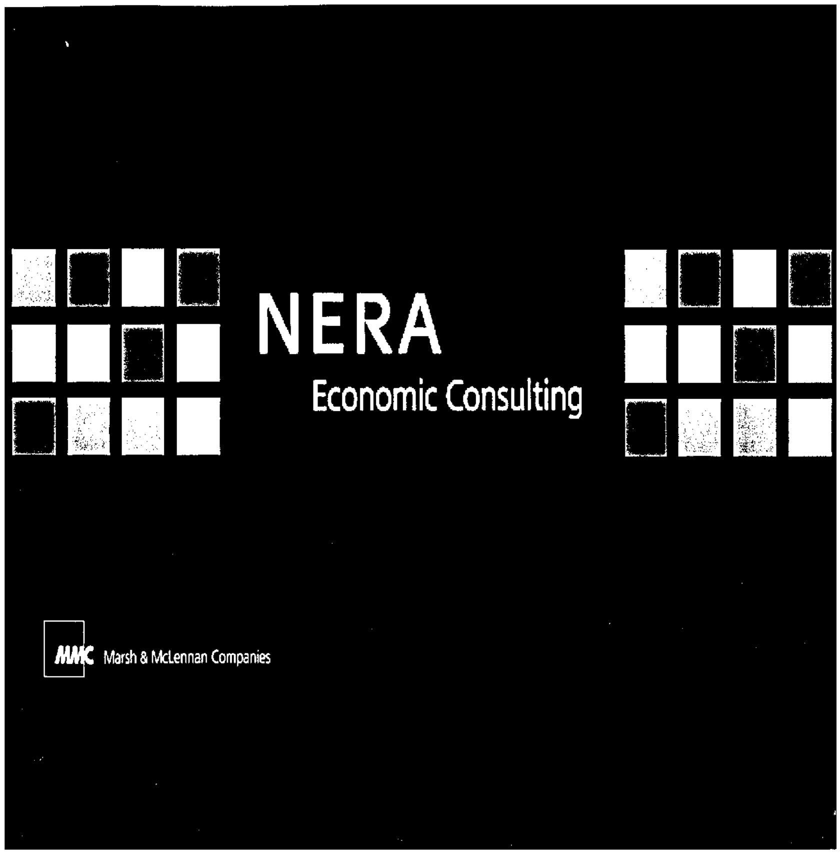
Conclusions

- Asbestos liabilities impose costs not just on shareholders
- Workers of the affected firms
  - Retraining
  - Health care availability and expense
- Local communities also can be hit hard
  - Other local business are hurt as people and jobs move out
  - Local property values will fall
  - Local governments face declines in revenues likely to be much greater than cost declines

Conclusions

Continued...

- Many other costs are passed on to taxpayers across the country
- These costs are expanding from year to year
  - 50,000 to 60,000 direct workers so far...
  - How many communities will be affected?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Economic Consulting
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Facts & Figures About Asbestos Litigation: Highlights from the New RAND Study

Stephen Carroll
Deborah Hensler

January 2003

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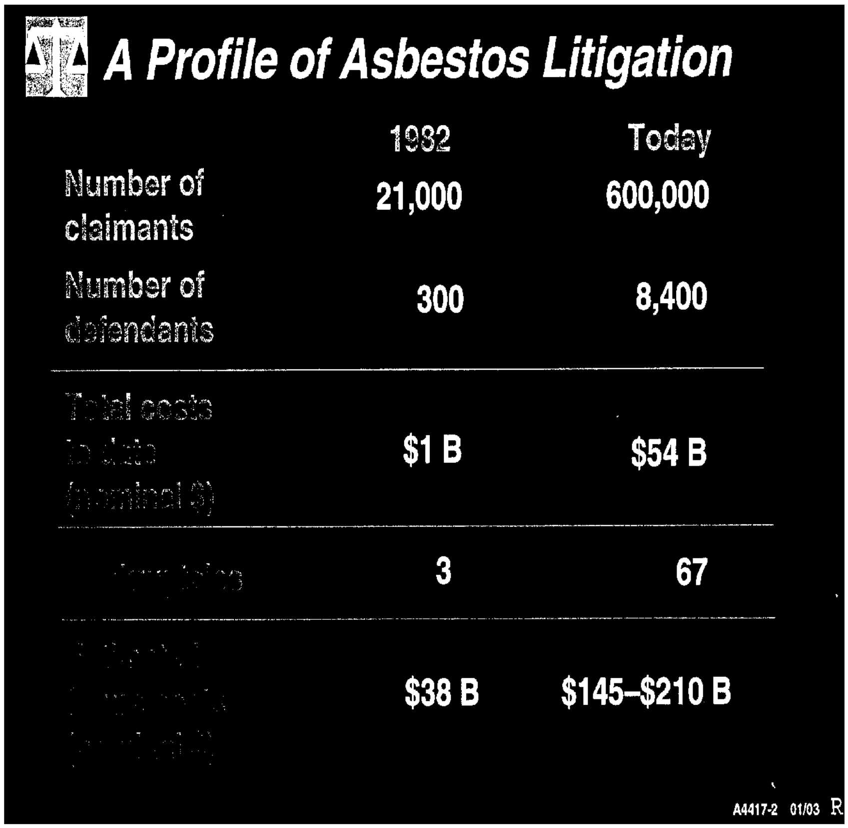
A Profile of Asbestos Litigation
1982
Today
Number of claimants
21,000
600,000
Number of defendants
300
8,400
Total costs
$1 B
$54 B
3
67
$38 B
$145–$210 B
A4417-2 01/03

RAND Research Approach

- Built on our previous asbestos and mass tort research
- Used publicly available data
- Obtained internal reports from investment and insurance analysts
- Acquired confidential data from litigation participants
- Conducted interviews with litigation participants

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Outline

- What are the numbers behind the profile?
- How did we get here?
- What are the consequences?

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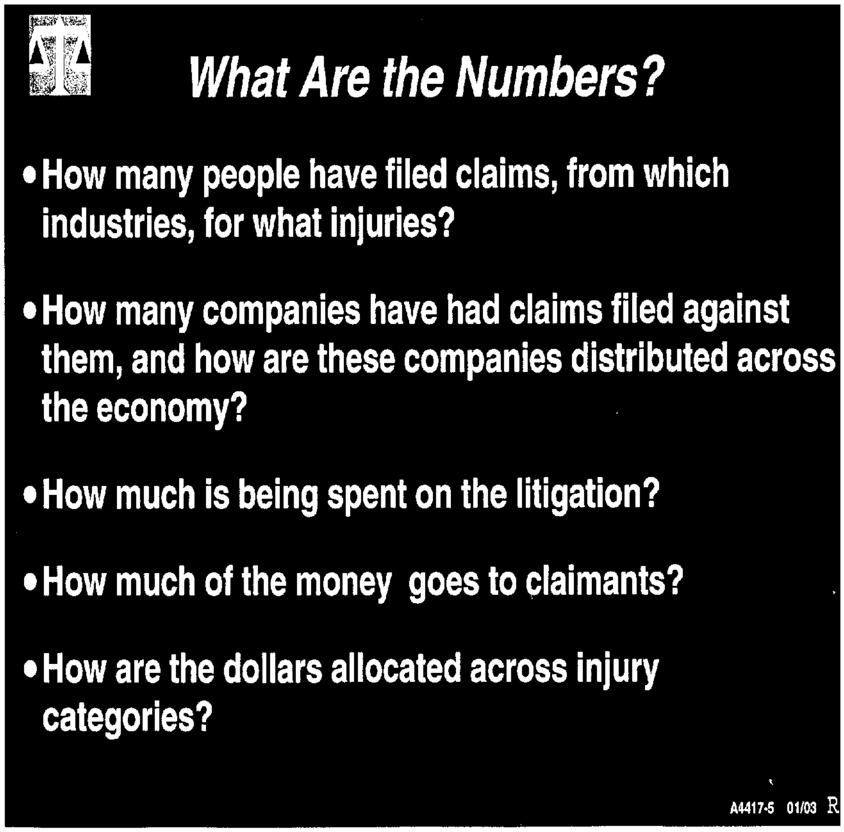
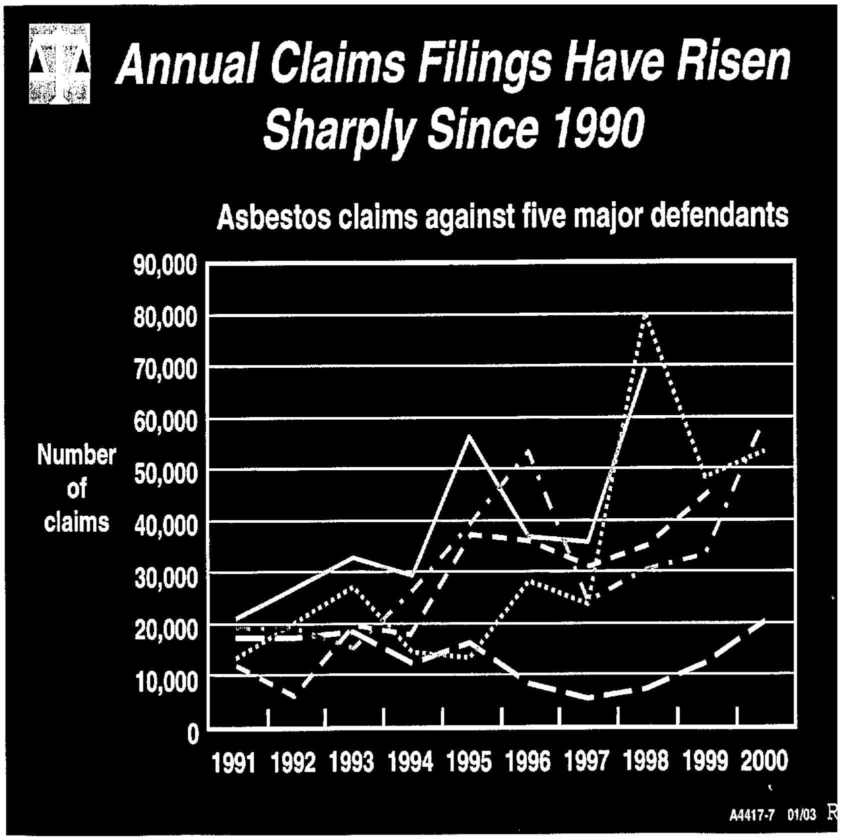
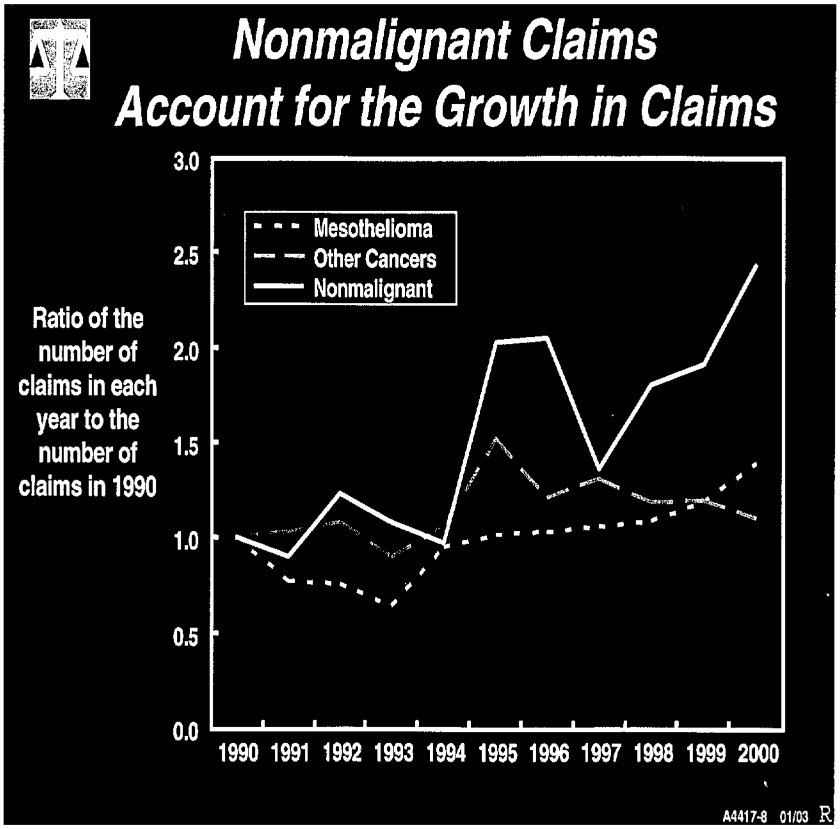

What Are the Numbers?
• How many people have filed claims, from which industries, for what injuries?
• How many companies have had claims filed against them, and how are these companies distributed across the economy?
• How much is being spent on the litigation?
• How much of the money goes to claimants?
• How are the dollars allocated across injury categories?
A4417-5 01/03 R

Over 600,000 Claimants Through 2000

- Typical claimant files against several dozen defendants
- Number of claims filed annually has risen sharply
- Average severity of claimed injuries is declining
  - Little change in frequency of seriously ill claimants
  - Increasing proportion of claims for less serious injuries


Annual Claims Filings Have Risen Sharply Since 1990
Asbestos claims against five major defendants
Number of claims
90,000
80,000
70,000
60,000
50,000
40,000
30,000
20,000
10,000
0
1991 1992 1993 1994 1995 1996 1997 1998 1999 2000
A4417-7 01/03



Nonmalignant Claims
Account for the Growth in Claims
Ratio of the number of claims in each year to the number of claims in 1990
3.0
2.5
2.0
1.5
1.0
0.5
0.0
Mesothelioma
Other Cancers
Nonmalignant
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
A4417-8 01/03

Claims from Workers in Nontraditional Industries Are Growing Most Rapidly

	1999	2000	2001	% increase '99-00	% increase '00-01
Traditional	16,997	31,496	43,397	85	54
Nontraditional*	11,420	23,582	40,453	107	71

*Food and beverage, textiles, paper, glass, [illegible] nonferrous, durable [illegible] goods, etc.

Source: Claims Resolution Management Corporation, 2001.

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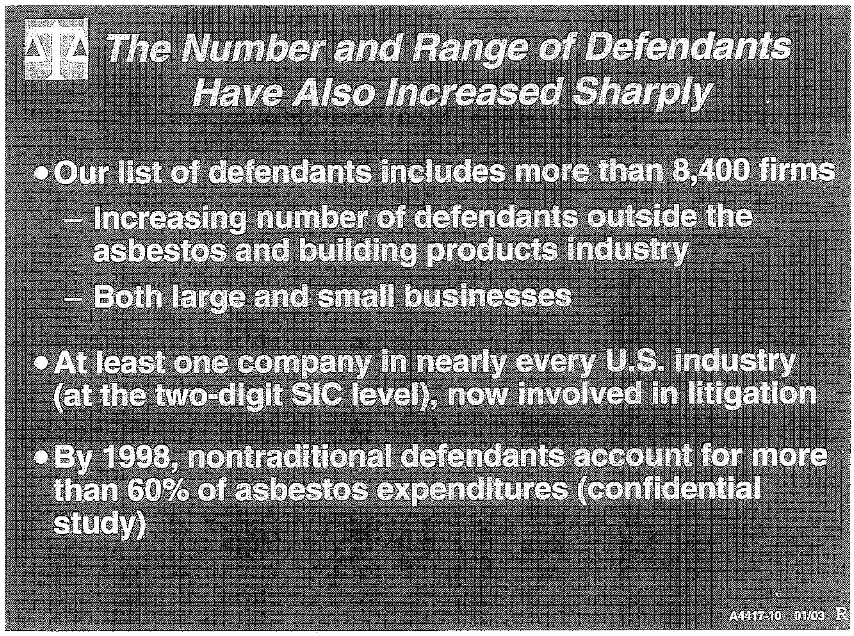
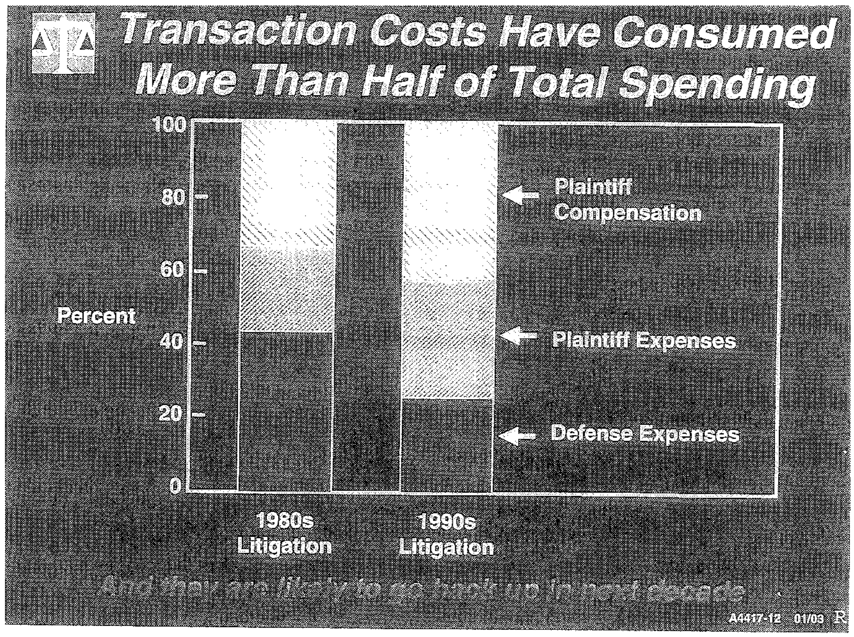
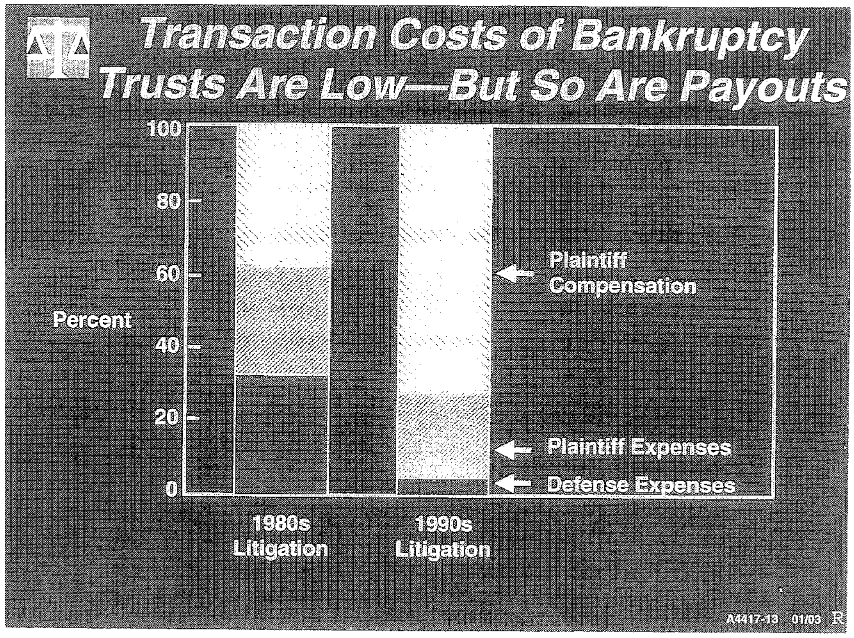

The Number and Range of Defendants Have Also Increased Sharply
• Our list of defendants includes more than 8,400 firms
– Increasing number of defendants outside the asbestos and building products industry
– Both large and small businesses
• At least one company in nearly every U.S. industry (at the two-digit SIC level), now involved in litigation
• By 1998, nontraditional defendants account for more than 60% of asbestos expenditures (confidential study)
A4417-10 01/03

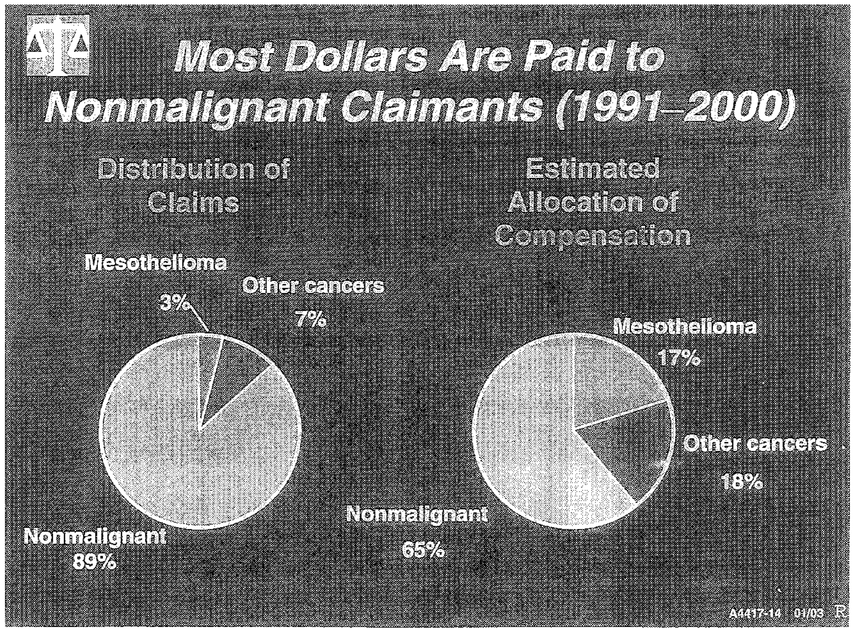
Estimated Total Costs of Resolving Asbestos Claims Through 2000: $54 B

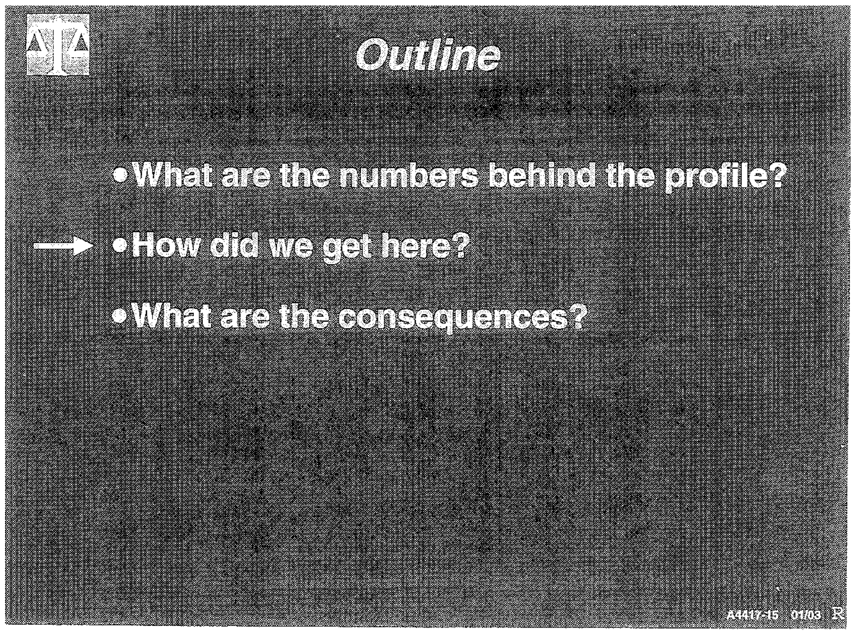
- Publicly available data are very limited
- We estimate total outlays of $54 B through 2000
  - U.S. insurers $22 B
  - Insurers outside U.S. $8–$12 B
  - Defendants $20–$24 B
- At least 5 major companies have each spent more than $1 B on asbestos litigation

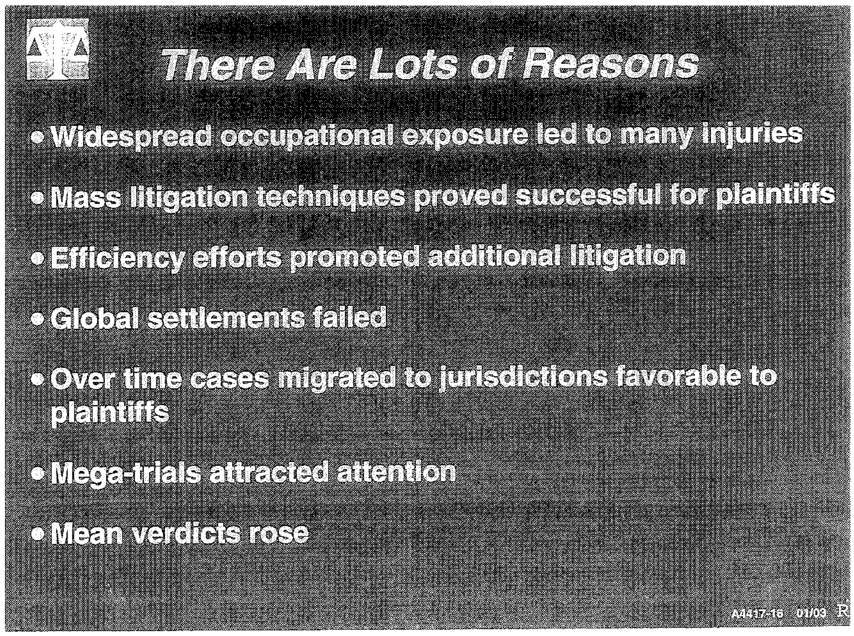
A4417-11 01/03

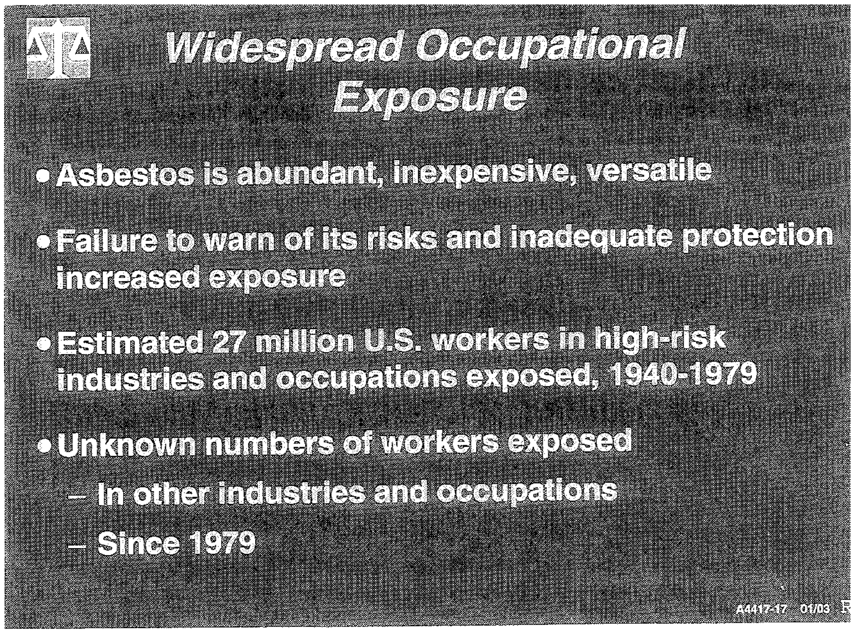

Transaction Costs Have Consumed
More Than Half of Total Spending
100
80
60
Percent
40
20
0
Plaintiff
Compensation
Plaintiff Expenses
Defense Expenses
1980s
Litigation
1990s
Litigation
And they are likely to go back up in next decade
A4417-12 01/03


Transaction Costs of Bankruptcy Trusts Are Low—But So Are Payouts
100
80
60
40
20
0
Percent
Plaintiff Compensation
Plaintiff Expenses
Defense Expenses
1980s Litigation
1990s Litigation
A4417-13 01/03


Most Dollars Are Paid to
Nonmalignant Claimants (1991–2000)
Distribution of
Claims
Mesothelioma
3%
Other cancers
7%
Nonmalignant
89%
Estimated
Allocation of
Compensation
Mesothelioma
17%
Other cancers
18%
Nonmalignant
65%
A4417-14 01/03


Outline
•What are the numbers behind the profile?
•How did we get here?
•What are the consequences?
A4417-15 01/03

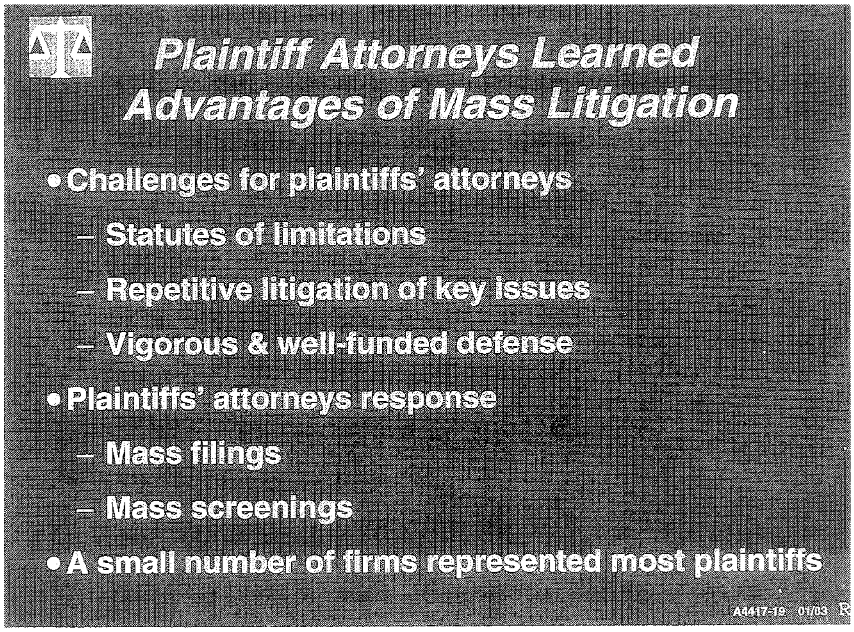

There Are Lots of Reasons
• Widespread occupational exposure led to many injuries
• Mass litigation techniques proved successful for plaintiffs
• Efficiency efforts promoted additional litigation
• Global settlements failed
• Over time cases migrated to jurisdictions favorable to plaintiffs
• Mega-trials attracted attention
• Mean verdicts rose
A4417-16 01/03


Widespread Occupational Exposure
• Asbestos is abundant, inexpensive, versatile
• Failure to warn of its risks and inadequate protection increased exposure
• Estimated 27 million U.S. workers in high-risk industries and occupations exposed, 1940-1979
• Unknown numbers of workers exposed
– In other industries and occupations
– Since 1979
A4417-17 01/03

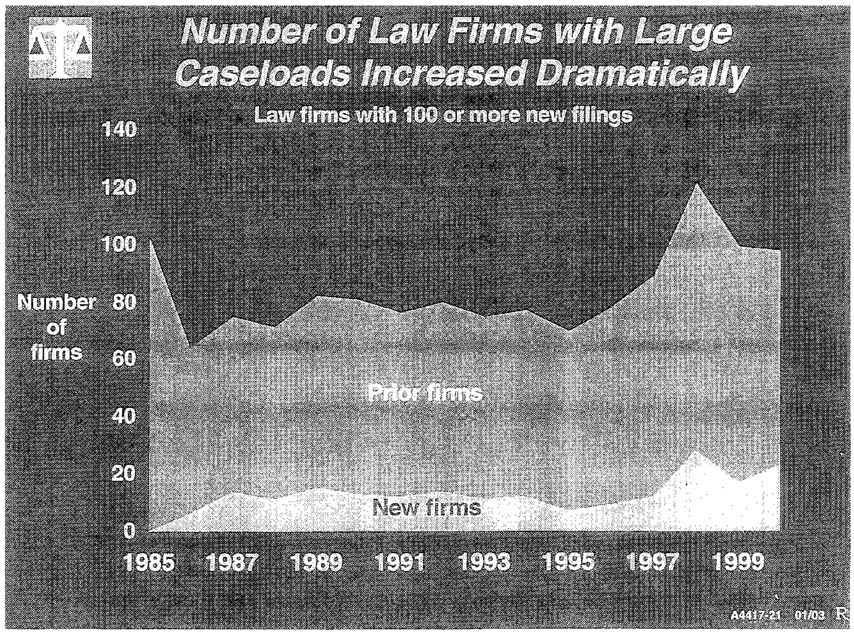
Many Injuries

- More than 225,000 premature deaths estimated through 2009
- Variety of diseases
  - Mesothelioma
  - Other cancers, particularly lung cancer
  - Asbestosis
  - Pleural thickening or plaques
- Studies suggest that most recent claimants without malignancies are not currently functionally impaired

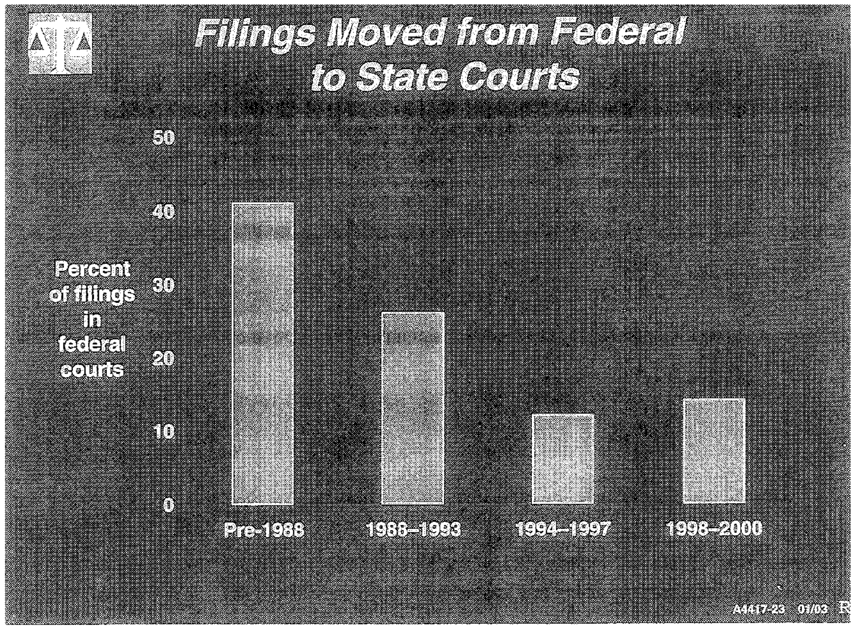
A4417-18 01/03 R

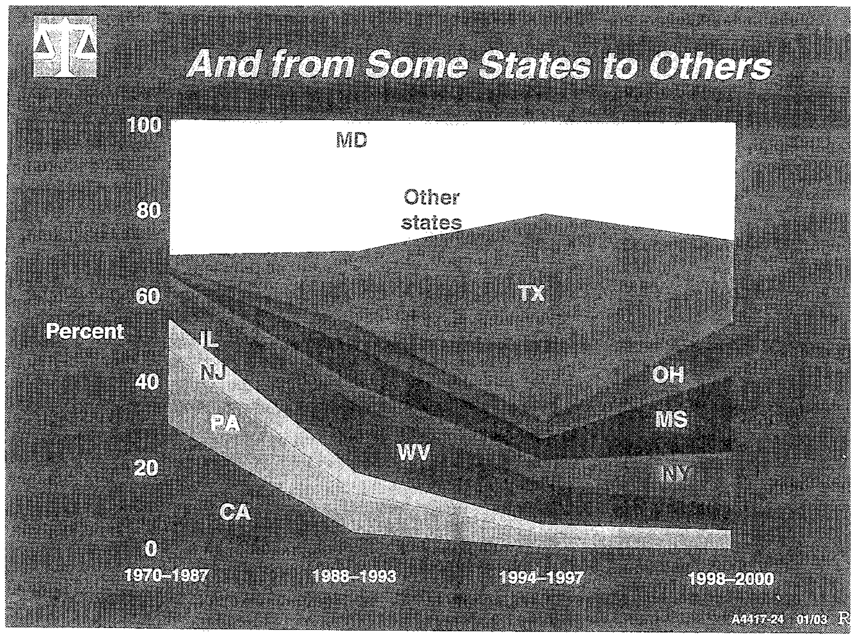

Plaintiff Attorneys Learned Advantages of Mass Litigation
• Challenges for plaintiffs' attorneys
– Statutes of limitations
– Repetitive litigation of key issues
– Vigorous & well-funded defense
• Plaintiffs' attorneys response
– Mass filings
– Mass screenings
• A small number of firms represented most plaintiffs
A4417-19 01/03


Efficiency Efforts Promoted
Additional Litigation
• Judicial case management
• Defendants' settlement programs
• Bankruptcy trust procedures
A4417-20 01/03


Number of Law Firms with Large Caseloads Increased Dramatically
Law firms with 100 or more new filings
140
120
100
Number of firms
80
60
40
20
0
Prior firms
New firms
1985
1987
1989
1991
1993
1995
1997
1999
A4417-21 01/03


Global Settlements Failed
• Multi-district litigation (MDL) did not produce a large-scale settlement
• Class action settlements overturned by U.S. Supreme Court
A4417-22 01/03


Filings Moved from Federal
to State Courts
Percent
of filings
in
federal
courts
50
40
30
20
10
0
Pre-1988
1988–1993
1994–1997
1998–2000
A4417-23 01/03


And from Some States to Others
100
80
60
40
20
0
Percent
MD
Other states
TX
IL
NJ
PA
CA
WV
OH
MS
NY
1970–1987
1988–1993
1994–1997
1998–2000
A4417-24 01/03

And To Venues Favorable to Plaintiffs

Top five state court venues

1970–1987	1988–1993	1994–1997	1998–2000
Los Angeles, CA	Kanawha County, WV	Harris County, TX	Cuyahoga County, OH
San Francisco, CA	Jackson County, MS	Galveston County, TX	Jefferson County, MS
Philadelphia, PA	Baltimore, MD	Jefferson County, TX	New York, NY
Baltimore, MD	Orange County, TX	Monongalia, WV	Baltimore, MD
Alameda, CA	Middlesex County, NJ	New York, NY	Claiborne County, MS

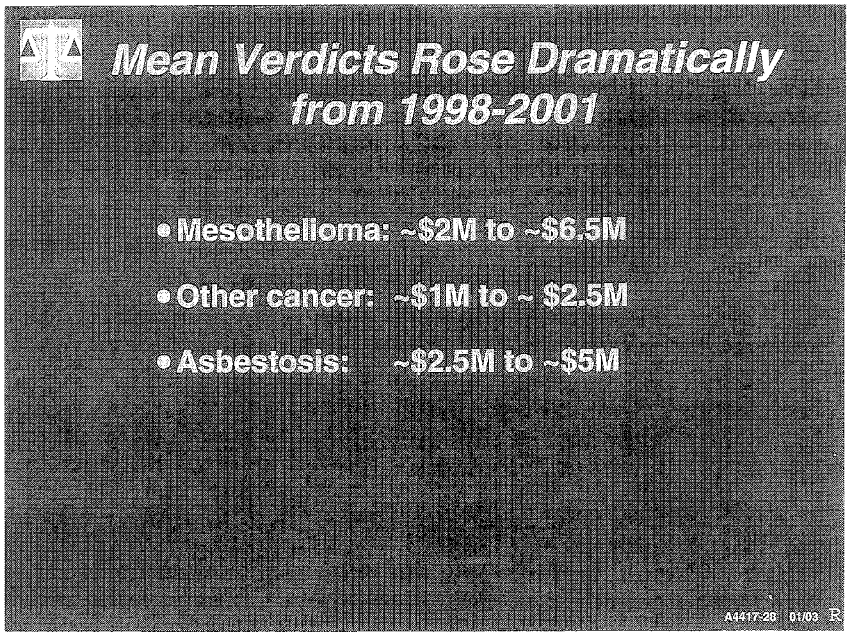
A4417-25 01/03 R

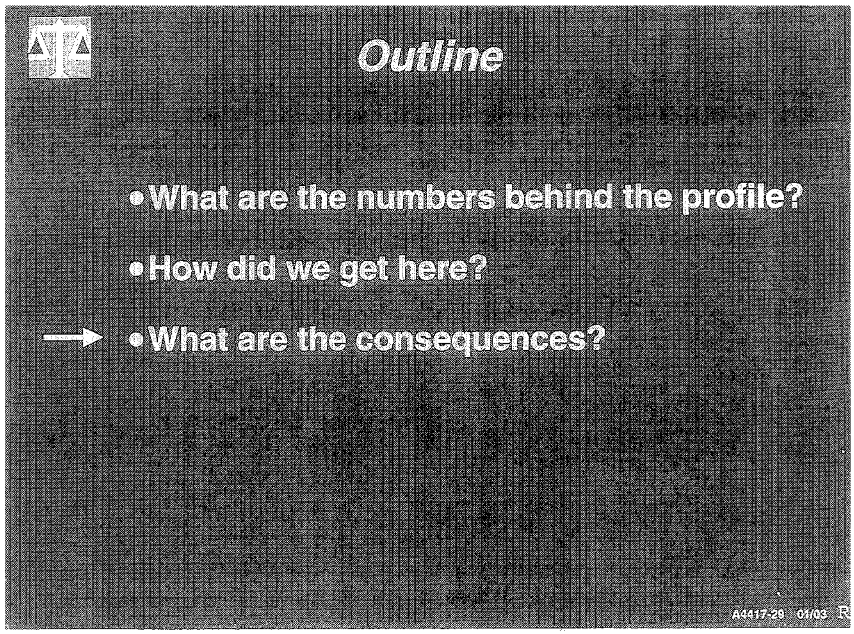

State Courts Redoubled Their Efforts
To Resolve Cases Efficiently
• Judicial case management
• Large-scale consolidation
These efforts often ignored effects on
litigation dynamics & outcomes
A4417-26 01/03

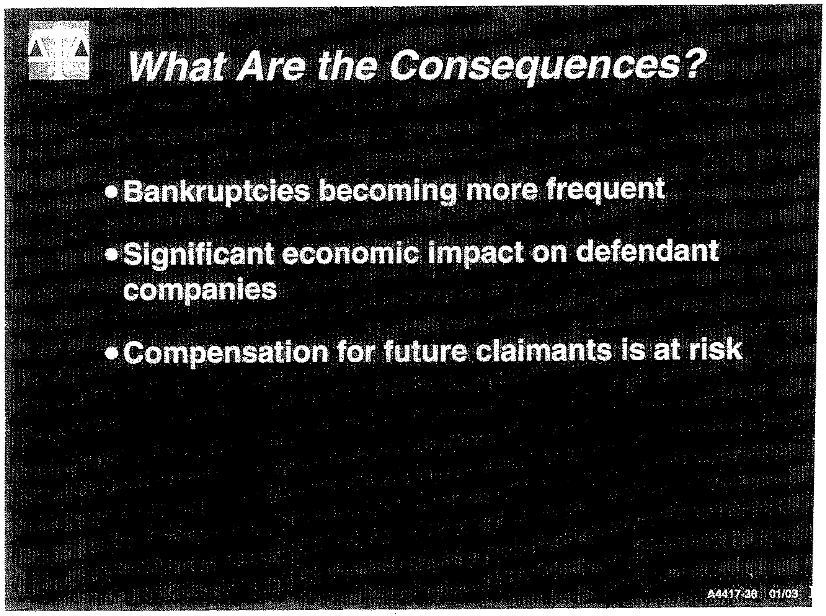
Mega-Trials Attracted Wide Attention

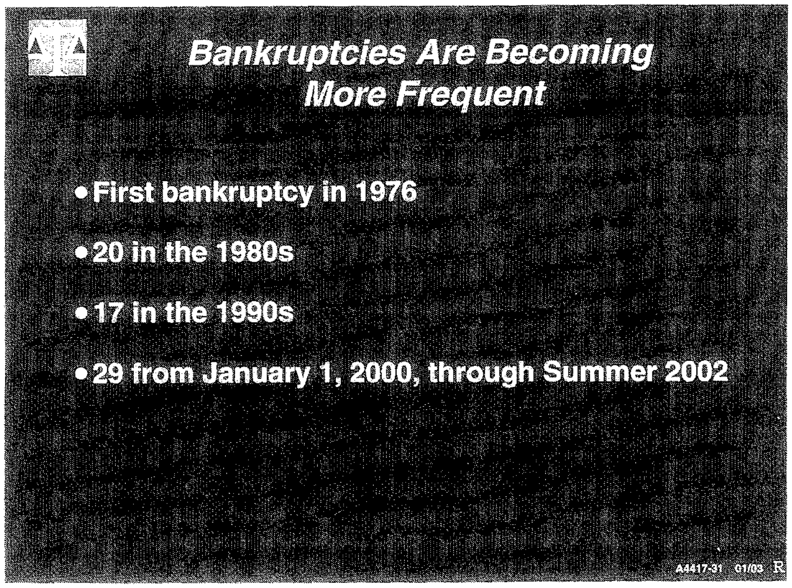
- 1993-2001: 527 trial verdicts, covering 1598 plaintiffs
- ~ 2/3 claims were tried in groups, most involving small number of plaintiffs & no absent plaintiffs
- 16 "mega-trials"
  - 8 intended to bind ~37,000 plaintiffs
  - 8 others, ~20,000 plaintiffs, tried in groups

A4417-27 01/03 R


Mean Verdicts Rose Dramatically from 1998-2001
• Mesothelioma: ~$2M to ~$6.5M
• Other cancer: ~$1M to ~ $2.5M
• Asbestosis: ~$2.5M to ~$5M
A4417-28 01/03


Outline
• What are the numbers behind the profile?
• How did we get here?
• What are the consequences?
A4417-29 01/03


What Are the Consequences?
• Bankruptcies becoming more frequent
• Significant economic impact on defendant companies
• Compensation for future claimants is at risk
A4417-38 01/03


Bankruptcies Are Becoming
More Frequent
• First bankruptcy in 1976
• 20 in the 1980s
• 17 in the 1990s
• 29 from January 1, 2000, through Summer 2002
A4417-31 01/03 R

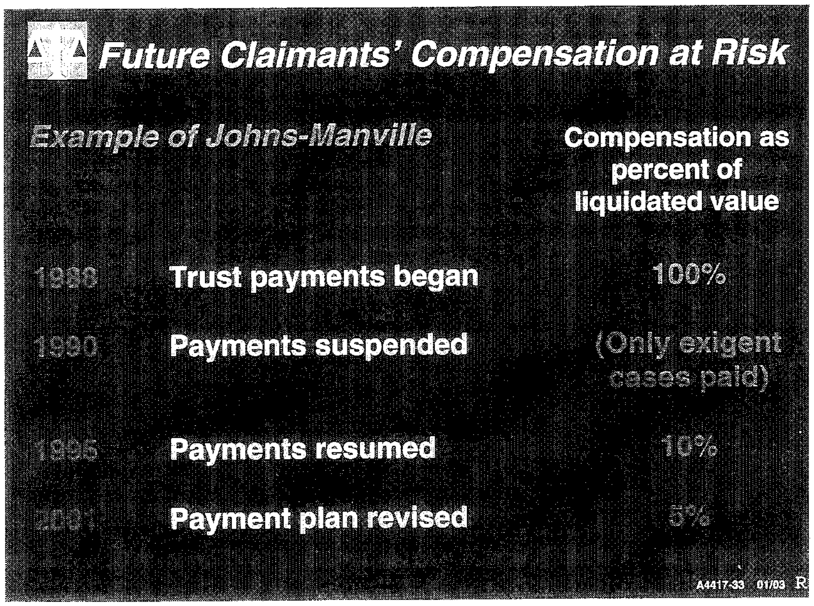
And Bankruptcy Is Only Part of the Story

- Defendants' net payments to asbestos claimants weaken their financial position, cost jobs
- Upper-bound estimates of effects on defendants:

	Today	Eventually
Reduced level of investment	$10 B	$33 B
Jobs not created	138,000	423,000

- However, other firms' reactions may offset the overall effects on the economy

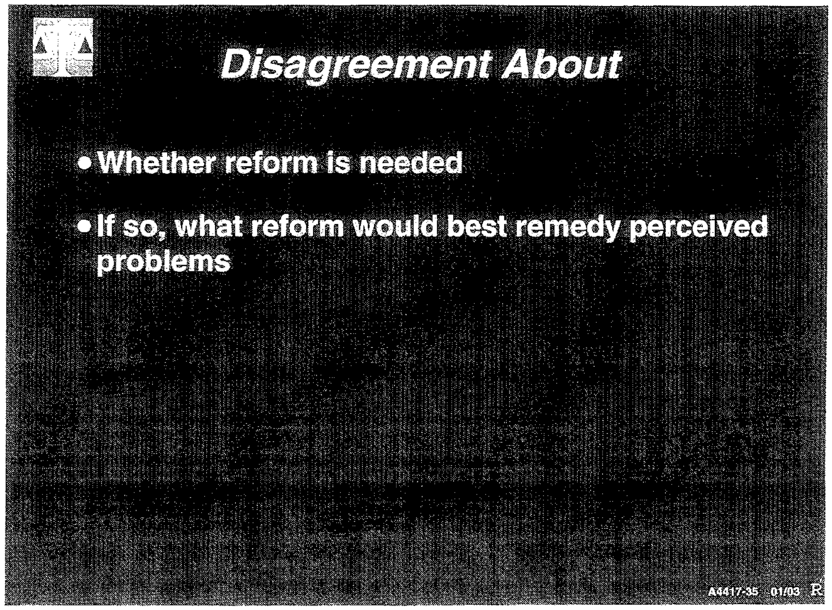
A4417-32 01/03


Future Claimants' Compensation at Risk
Example of Johns-Manville
Compensation as percent of liquidated value
1988
Trust payments began
100%
1990
Payments suspended
(Only exigent cases paid)
1995
Payments resumed
10%
2001
Payment plan revised
5%
A4417-33 01/03

There Is Widespread Agreement About the Current State of the Litigation...

- Recent surge in filings
- Majority of recent claimants are not currently functionally impaired
- High transaction costs
- Large number of bankruptcies
- Spread of litigation through economy
- Future claimants' prospects are uncertain

A4417-34 01/03 R


Disagreement About
• Whether reform is needed
• If so, what reform would best remedy perceived problems
A4417-35 01/03

THE BUDGET AND ECONOMIC OUTLOOK

THURSDAY, JANUARY 30, 2003

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. Don Nickles (chairman of the committee) presiding.

Present: Senators Nickles, Domenici, Allard, Sessions, Crapo, Ensign, Conrad, Sarbanes, and Stabenow.

Staff present: Hazen Marshall, staff director; and Cheri Reidy, senior analyst.

For the minority: Mary Ann Naylor, staff director; Jim Horney, deputy staff director and Sue Nelson, deputy staff director.

OPENING STATEMENT OF CHAIRMAN DON NICKLES

Chairman NICKLES. The committee will come to order.

I want to thank our members. My guess is we will have a few more members shortly. I want to thank Mr. Anderson for joining us today. I think most everybody around here has had the pleasure of getting to know Barry Anderson. I compliment him for his many years of service in the fields of budgeteering. He has got about 30 years of budget experience and expertise. He has worked at the General Accounting Office; he has worked at OMB for many years. Since 1999, he has been at the Congressional Budget Office as Deputy Director. So, Mr. Anderson, we welcome you to our committee again.

Before we proceed, I think I will call upon my colleague, Senator Conrad, for any opening remarks, if any, that he might have.

OPENING STATEMENT SENATOR CONRAD

Senator CONRAD. Thank you, Mr. Chairman.

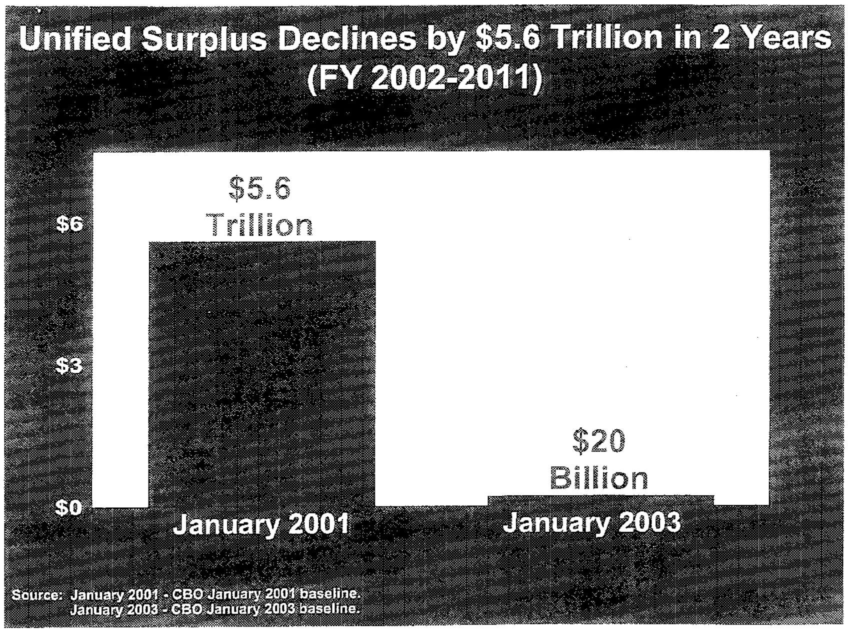
I want to echo what the Chairman has said in commending Dr. Anderson for his service. We appreciate it very much. We know you could have certainly made more money in the private sector, but your dedication to public service is deeply appreciated, both in the executive branch of Government and certainly here. I am reminded that it was 2 years ago that you were here testifying on behalf of Dan Crippen, who was the CBO Director and who had been injured in a terrible accident. So you were here at that time giving us the view that we were going to be in this very advantageous circumstance of having nearly $6 trillion of budget surpluses over the next decade.

What a dramatic change from those happy days: $5.6 trillion, we were told, over the next decade in surpluses; now with your new report today, down to $20 billion. That, of course, is based on no policy changes, no additional spending, no additional tax cuts. We all know that the President has laid on the table significant changes: additional tax cuts, making the tax cuts permanent, his growth package, which is virtually all tax cuts, additional spending on prescription drugs and Medicare reform. Obviously there will be additional costs if we go to war with Iraq. Those are not expressed in the numbers that the Acting Director will give us today.

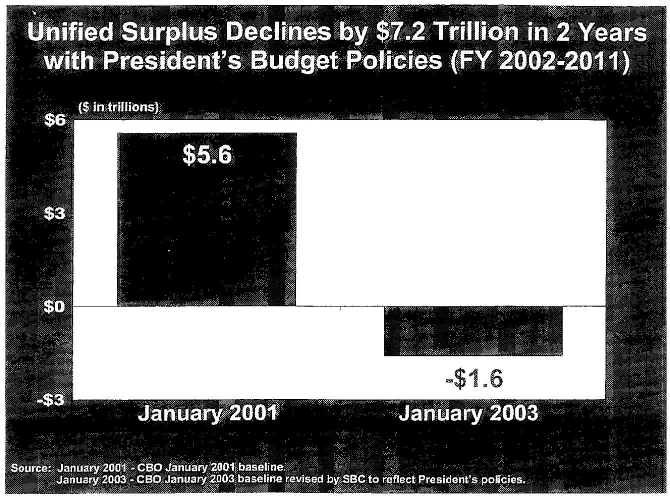
President Bush's Budget Policies

($ billions)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2002-11	2003-13
Extend expiring provisions in 2001 tax bill	0	0	1	4	13	19	24	28	32	156	249	260	276	785
Allow 4% growth in discretionary programs	0	7	15	18	19	20	21	21	22	22	23	24	165	211
President's economic stimulus plan	0	35	122	89	64	56	56	55	50	46	50	53	571	674
Likely FY 2003 supplemental	0	8	20	6	3	1	0	0	0	0	0	0	39	39
Medicare reform and drug benefit	0	0	0	0	25	35	40	45	50	60	70	75	255	400

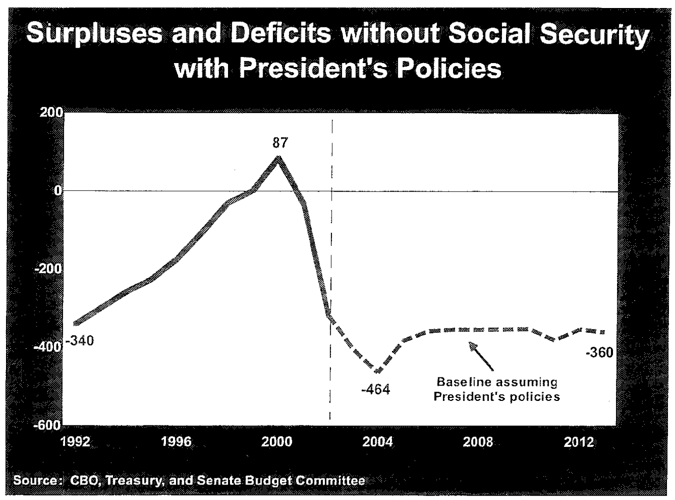
Source: Congressional Budget Office and Senate Budget Committee Democratic Staff.


Unified Surplus Declines by $5.6 Trillion in 2 Years
(FY 2002-2011)
$6
$3
$0
$5.6 Trillion
$20 Billion
January 2001
January 2003
Source: January 2001 - CBO January 2001 baseline.
January 2003 - CBO January 2003 baseline.

If we take into account those changes, the changes the President has proposed in policy, what we see over the next decade is not any surplus, not $5.6 trillion, not $20 billion, but no surpluses; but instead we would be $1.6 trillion in the red.



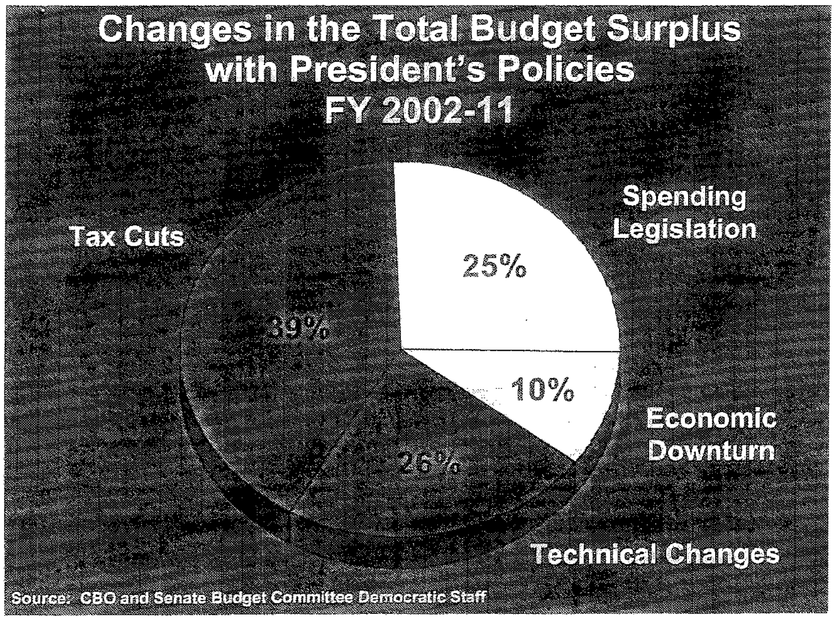
Let's go to the next chart. Frankly, of greatest concern to me is that not only do we see deficits as far as the eye can see, but if we also take out Social Security, if we are not taking Social Security funds and using those to pay for tax cuts and using those for other purposes, what we see is really an ocean of red ink out ahead of us for the entire rest of the decade, deficits that are what I would call "operating deficits," a more accurate reflection of the real deficits of the Federal Government, running in the $300 to $400 billion a year range throughout the entire rest of the decade.



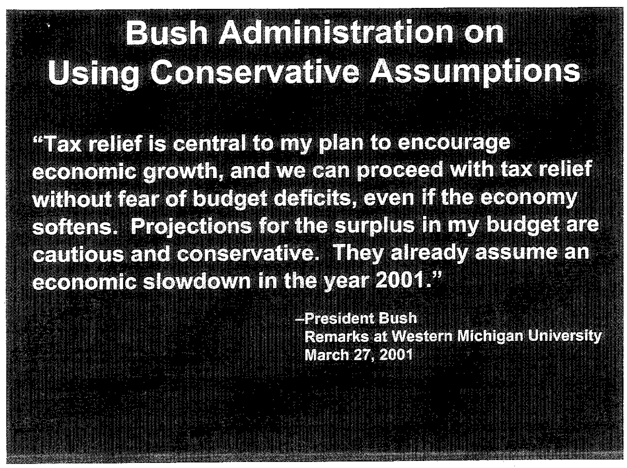
The question becomes: Where did the money go? Where did this $7 trillion turn—where did all those dollars go? What we see is the biggest reason is the tax cuts, both those that have already been enacted and those proposed. The second biggest reason is technical changes, largely that the revenue models, the revenue being generated is not what was anticipated, given the various levels of economic activity, really that revenue was being overestimated quite apart from the tax cuts.

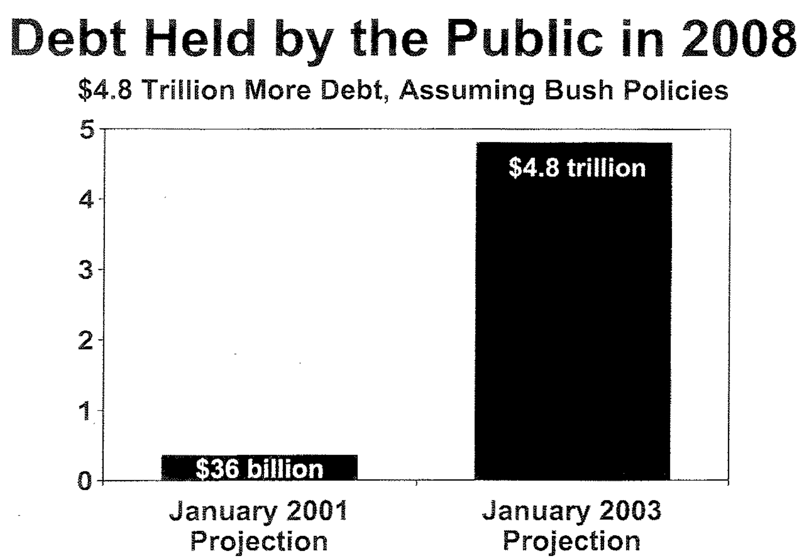
The second biggest reason is spending, 25 percent of the reason of the disappearance of the surpluses, spending that has already occurred and that is projected to occur under the President's plans. Most of that obviously has gone for defense and homeland security.

Then the smallest part is the economic downturn, some 10 percent of the reason for the disappearance of the surplus.


Changes in the Total Budget Surplus
with President's Policies
FY 2002-11
Spending
Legislation
Tax Cuts
25%
39%
10%
Economic
Downturn
26%
Technical Changes
Source: CBO and Senate Budget Committee Democratic Staff

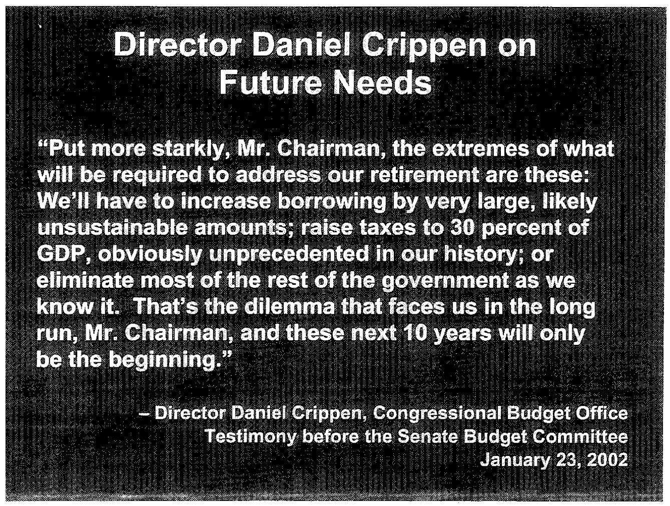
Let's go to the next chart. This leaves us with very unfortunate results with respect to the national debt. You will recall the President told us in his plan of 2 years ago that he was going to have maximum paydown of the debt. That is not what we see now. Instead, we see substantial increasing of the debt. In fact, the debt by 2008, when the President said his plan would allow for virtual elimination of the debt, instead we will have a debt of some $4.8 trillion. Again, that is publicly held debt.





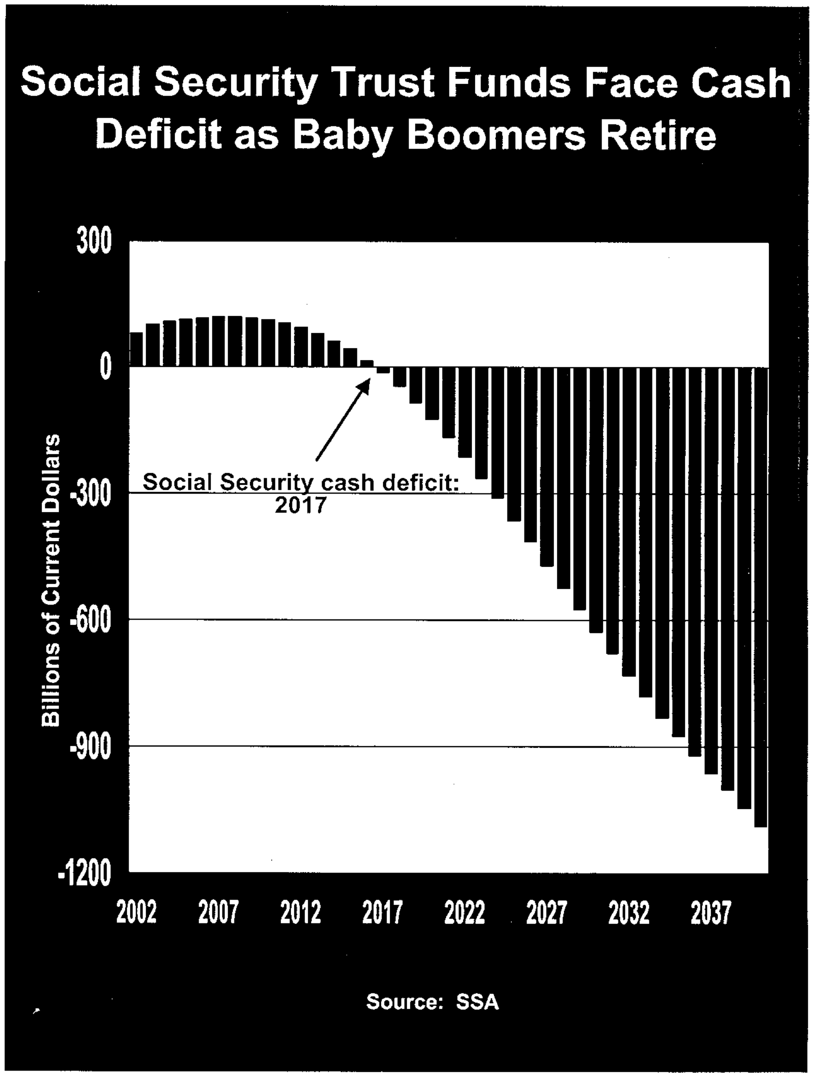
Source: CBO, Treasury, and Senate Budget Committee

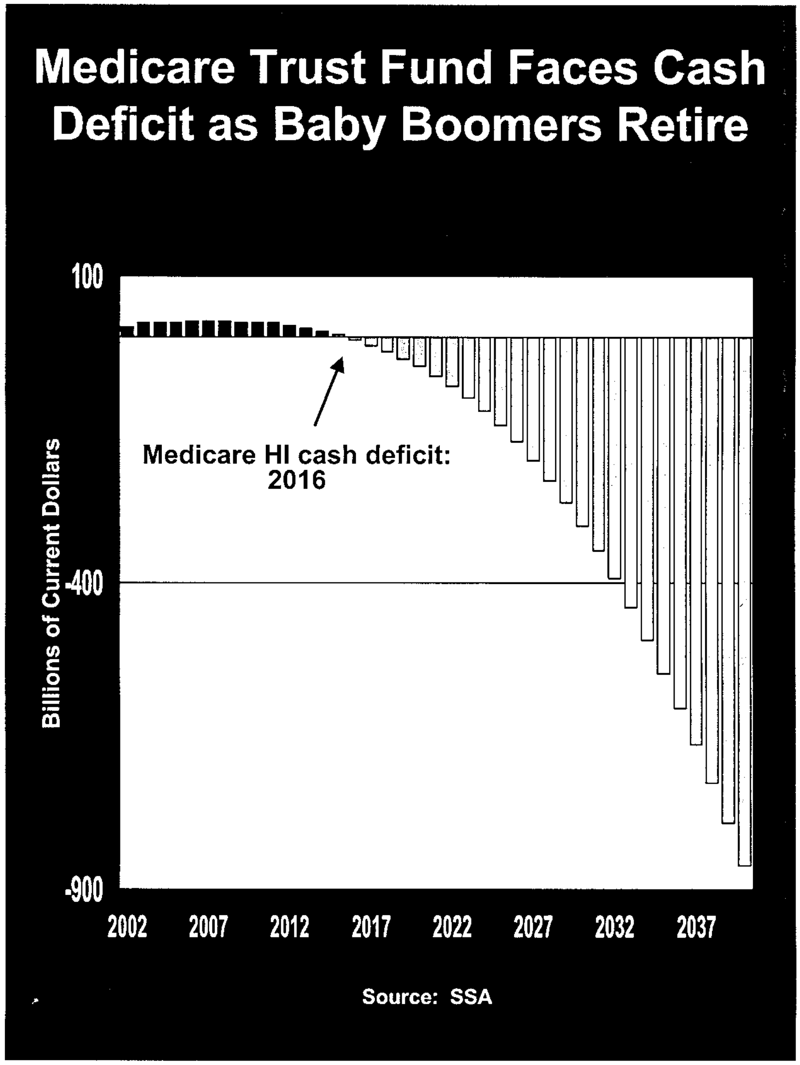
Why does all this matter so much? Well, Director Crippen testified here last year, saying "as we look ahead, put more starkly, Mr. Chairman, the extremes of what will be required to address our retirement are these: we will have to increase borrowing by very large, likely unsustainable amounts; raise taxes to 30 percent of GDP, obviously unprecedented in our history; or eliminate most of the rest of Government as we know it."



Then he concluded that is the dilemma that faces us in the long run, Mr. Chairman, and these next 10 years will only be the beginning.

Let me just put up a final chart that I want to show this morning, and that is, here is what he was talking about. We are in the sweet spot of the fiscal cycle now; that is, the trust funds of Social Security and Medicare are running surpluses now. When we get Social Security out to 2017, the baby-boom generation has started to retire, the trust fund goes cash negative. When it does, it goes cash negative in a very significant way, very dramatic. That is why I have always believed during this period we should not be running deficits at all, that, in fact, we should either be paying down debt or we should be prepaying the liability that is to come. Unfortunately, we are doing neither, and the President's plan digs the hole deeper, much deeper, a hole that is really stunning, approaching $4 trillion over the next decade when one safeguards the Social Security funds, which virtually everyone in Congress had pledged to do.


Social Security Trust Funds Face Cash Deficit as Baby Boomers Retire
300
0
-300
-600
-900
-1200
Billions of Current Dollars
Social Security cash deficit: 2017
2002
2007
2012
2017
2022
2027
2032
2037
Source: SSA


Medicare Trust Fund Faces Cash Deficit as Baby Boomers Retire
100
-400
-900
Billions of Current Dollars
Medicare HI cash deficit: 2016
2002
2007
2012
2017
2022
2027
2032
2037
Source: SSA

President's Plan Would Undermine Potential GDP

"Initially the plan would stimulate aggregate demand significantly by raising disposable income, boosting equity values, and reducing the cost of capital. However, the tax cut also reduces national saving directly while offering little new, permanent incentive for either private saving or labor supply. Therefore, unless it is paid for with a reduction in federal outlays, the plan will raise equilibrium real interest rates, "crowd out" private-sector investment, and eventually undermine potential GDP."

–Macroeconomic Advisers, LLC
January 10, 2003

With that, Mr. Chairman, I look forward to the testimony of our witness and questions of our colleagues.

Chairman NICKLES. I didn't make any opening comments because I was afraid you were going to make some of yours. [Laughter.]

Chairman NICKLES. Just for the information of our witness and also Senator Burns, we have a Finance Committee vote at 10:15. They are trying to get that done. I just wonder if we should gamble on that.

I think we will go ahead. Let me make a few remarks, since we only have to run downstairs. So we won't go down until they tell us they need us, and we just have to go down a couple flights, and we can be back in 5 minutes. Let me make——

Mr. ANDERSON. I promise not to change the numbers in between time.

Chairman NICKLES. I appreciate that, Mr. Anderson. Thank you. I just want to make a couple comments.

One, I don't concur with the analysis of my friend and colleague Senator Conrad, and while I do think people are entitled to their opinions, they are not entitled to their facts. I will just throw out a couple of facts, and I will insert these into the record. I think we would agree—one of the comments that Senator Conrad mentions—that CBO and OMB, and, I might mention, every other analyst, misjudged total revenue estimations for 2001 and 2002 and, frankly, for the out-years big time, in trillions of dollars. Certainly—well, I say in trillions. I would have to extrapolate that, and I will ask you a question, but the forecast that Senator Conrad was alluding to, the $5.6 trillion surplus that was forecast in January 2001 over that 10-year period of time, I would just look back to 2002. This is factual. We have 2002 numbers. CBO projected in 2002 there would be a surplus of $313 billion. Congress enacted a few changes. We cut some taxes, a total of $75 billion, and we increased some spending, a total of $75 billion. The economic and technical re-estimates were $321 billion. CBO missed it big time. That was 68 percent of the difference, not an insignificant amount. It is 68 percent of the difference if you want to look at what happened in 2002, because the year before we had a $127 billion surplus. In 2002, we had a $158 billion deficit. Big swing. Why? Three hundred twenty-one of it is economic and technical re-estimates. Most of that, where the CBO was off, where OMB was off, where we were off, was you had a precipitous drop in income. You had a decline of income of 7 percent. That is historic in any estimation. It followed, I might mention, a reduction of income in 2001 of about 1.7 percent.

So never, or certainly not in recent decades have we had two consecutive years of reduction of income no one estimated and a total combined—if you add the 2 years together—of about 9 percent reduction. A bunch of this nonsense on the charts, well, this is caused by tax cuts and so on, just doesn't bear out. It is not factual.

Well, I want to be very factual. I am adamant that we be factual.

Senator CONRAD. I agree with that absolutely. Let's be factual. I mean, what I put up here, there was nothing here that wasn't factual.

Chairman NICKLES. Let me finish. I want to be factual, and I am going to insert this into the record. We did go from a $127 billion surplus in 2001 to a $150 billion deficit in 2002, and according to my chart—and maybe I will ask Mr. Anderson to substantiate this, but we got this from him—I believe that $321 billion of that change was due to economic and technical re-estimates.

Changes in CBO's Baseline Projections of the Surplus Since January 2001 January 2003 Adjusted Baseline

[by fiscal year, in billions of dollars]

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002—2011
Total Surplus as Projected in January 2001	281.118	312.934	359.148	396.809	432.940	504.996	572.721	635.089	710.386	795.963	888.707	5,609.693
Changes to Revenue Projection.												
Legislative.												
EGTRRA	(70.208)	(31.338)	(84.003)	(100.697)	(100.318)	(125.606)	(142.120)	(150.709)	(158.152)	(175.921)	(117.284)	(1,186.148)
Economic Stimulus	0.000	(42.591)	(39.406)	(29.062)	(3.548)	16.101	16.814	16.042	13.666	10.140	7.246	(34.598)
Other	(0.999)	(0.630)	(2.900)	(3.125)	(3.351)	(3.440)	(1.637)	(1.345)	(1.352)	(1.527)	(1.516)	(20.823)
Subtotal, legislative	(71.207)	(74.559)	(126.309)	(132.884)	(107.217)	(112.945)	(126.943)	(136.012)	(145.838)	(167.308)	(111.554)	(1,241.569)
Economic & Technical	(72.334)	(307.949)	(295.215)	(265.766)	(237.498)	(205.784)	(184.082)	(171.476)	(162.862)	(154.810)	(115.446)	(2,100.888)
Total Revenue Changes	(143.541)	(382.508)	(421.524)	(398.650)	(344.715)	(318.729)	(311.025)	(307.488)	(308.700)	(322.118)	(227.000)	(3,342.457)
Changes to Outlay Projections.												
Legislative.												
Discretionary	1.515	50.242	77.431	82.091	84.455	84.629	85.260	86.017	87.231	89.432	91.667	818.455
Mandatory.												
EGTRRA	0.000	6.226	6.600	7.006	7.081	9.597	9.542	9.360	9.668	11.080	12.244	88.404
Economic Stimulus	0.000	8.278	3.526	0.036	0.023	(0.014)	(0.040)	(0.036)	(0.010)	0.003	0.003	11.769
Farm Bill	0.000	1.613	8.406	9.854	10.212	9.867	9.253	8.072	8.037	7.519	7.273	80.106
Debt Services	0.537	4.937	14.779	30.259	45.387	60.078	75.838	93.138	111.895	132.551	153.559	722.421
Other Mandatory	11.432	4.072	14.942	6.154	5.892	3.045	2.257	4.178	3.172	3.127	3.281	50.120
Subtotal, mandatory	11.969	25.126	48.253	53.309	68.595	82.573	96.850	114.712	132.762	154.280	176.360	952.820
Subtotal, legislative	13.484	75.368	125.684	135.401	153.050	167.202	182.110	200.729	219.993	243.712	268.027	1,771.275
Economic & Technical.												
Discretionary	1.340	1.085	4.528	5.205	(0.353)	(2.074)	(0.856)	0.834	3.278	5.436	11.323	28.406
Mandatory	(4.350)	12.325	6.594	2.532	8.591	37.617	54.326	61.132	75.148	84.286	105.167	447.718
Subtotal, econ. & tech.	(3.010)	13.410	11.122	7.737	8.238	35.543	53.470	61.966	78.426	89.722	116.490	476.124
Total Outlay Changes	10.474	88.778	136.805	143.138	161.288	202.745	235.580	262.695	298.419	333.434	384.518	2,247.399
Total Impact on Surplus	(154.015)	(471.286)	(558.329)	(541.788)	(506.003)	(521.474)	(546.605)	(570.183)	(607.119)	(655.552)	(611.518)	(5,589.856)
Total Surplus or Deficit (-) as projected in January 2003	127.103	(158.352)	(199.181)	(144.979)	(73.063)	(16.478)	26.116	64.906	103.267	140.411	277.189	19.837
Memorandum:.												
Total legislative changes	(84.691)	(149.927)	(251.993)	(268.285)	(260.267)	(280.147)	(309.053)	(336.741)	(365.831)	(411.020)	(379.581)	(3,012.844)
Total econ & tech changes	(69.324)	(321.359)	(306.337)	(273.503)	(245.736)	(241.327)	(237.552)	(233.442)	(241.288)	(244.532)	(231.936)	(2,577.012)

I happen to think instead of us just pointing fingers back and forth, I think it would be wise for us to figure out how we can get the growth in our economy again so those estimates can be more accurate on the income side.

I might also mention in 2003, I believe CBO projects that we will have a deficit of $199 billion. In 2001, CBO projected that we would have a surplus of $359 billion. There is a big difference there, a total of $558 billion difference; $126 billion was due to legislative changes on the Tax Code. We cut taxes $126 billion. I might mention bipartisan tax cuts. That is both President Bush's tax cut and also the bipartisan stimulus act that totaled $126 billion.

Then we also had spending increases that totaled $126 billion. It is very interesting how both the spending and the taxes equaled changes from the baseline. We also had $306 billion in technical and economic re-estimates. That is 55 percent of the difference.

So, again, there is a big difference between the estimate that was made in 2001 for surplus in 2003 of $359 billion when we went to a deficit projected to be $199 billion, most of which, the majority of which was re-estimates because of the reduction in incomr. We didn't meet the targets. Why didn't we meet the targets? It wasn't because of the tax cut. The tax cut was part of it, but a very small part. Spending increases was part of it. The majority of it was re-estimating the economic forecast.

So I just mention that. I think it is important to try and look at history, but I also think—and, Mr. Anderson, this kind of may be my opening—CBO has missed it a lot. In your statement—I read your statement that you are going to present to the Committee. I have read it, and you have kind of a window of these—I think you have a chart that is called the uncertainty of your projections, and it shows the figures.

Now, you stopped on 1997, but as I mentioned, CBO really missed it in 2001 and 2002, and I don't know why you didn't show those, because that is where—you know, trying to guess what the budget is going to be in 10 years to me is more hypothetical than anything else. We missed it big time. In 2001, we missed it big time for 2002 and 2003. Even last year, we missed it big time.

I am not being critical. You are a professional. You work with great people. Everybody missed it. No one projected that big of a reduction in revenues.

Now, part of the problem—could we have that Nasdaq chart? Part of the problem happened because of the stock market. The market decline precipitously, and it has caused all of us, myself included, a significant reduction in our accounts. In 2000, Nasdaq fell from its peak 45 percent, and that reduced my IRA account, and it reduced millions of Americans'. I don't think anybody projected how that was going to flow through the system.

So I am not faulting, but I do know that you or OMB—CBO, excuse me, and OMB testified before the Committee, and they grossly overestimated the amount of money that was going to be received. Even when they testified January 2001, we had already had a major decline in stock values, unparalleled, but estimates were just way off. On January 1, no one was projecting that revenues would be declining by 7 percent in 2002, or even a reduction in 2001.

Now, granted, in 2001, we didn't know September 11th was coming. That had a dramatic impact, no doubt. On January 1 of 2002, that had already happened, but we still had—in 2002 is when we had the biggest reduction of income. September 11th had already happened. Again, I am not faulting. These are unintended consequences maybe as a result of September 11th. Everybody, all the professionals, missed the total estimates coming into the Government big time, by hundreds of billions of dollars. We had total revenues—correct me if I am wrong—of $2.25 trillion in the year 2000, and last year they were $1.85 trillion. That is a reduction of $175 billion compared to 2 years before, not to mention from what was projected, which was much higher. CBO missed it big time, and so did everybody else.

So, Mr. Anderson, you are my friend, but we all have to do a better job. I take some responsibility now that I am chairing this committee. I really want to do a better job. I want to do a better job in fiscal management of the Government, all the Government. I look forward to working with you to accomplish that goal. You are an accomplished professional. You have done a fantastic job. You have some great people. CBO, OMB, everybody missed the estimates big time in 2002, and I did note in your report that you project that we have a deficit this year of $199 billion and that deficit declines if we stay with present law, declines basically to a balanced budget in 2006. We are working on 2004's budget, so in 3 or 4 years, 2007, it would be balanced.

Congress is also looking at some changes—growth package, prescription drugs, could have a military conflict that could influence that as well.

So I mention this. I would like an explanation from you, if possible, in your comments as to how did CBO miss it so much and how can we do a better job in estimating revenues.

I might mention you have done very well in estimating outlays. You are on target on your outlay estimates. Everybody missed it on revenues. Maybe if we could figure out modeling or something to where we could do a better job on the revenue estimates, I think it would be helpful for the future.

So with that comment, I welcome you to the Committee, and, again, I will apologize. In a second I think we are going to have to run downstairs. Welcome again before our committee.

STATEMENT OF BARRY B. ANDERSON, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ANDERSON. Thank you, Mr. Chairman. Thank you for your kind comments, and yours, Senator Conrad. I had hoped to make my career more than that of super sub, but I am glad to be here anyway and to talk about the Congressional Budget Office's economic and budget projections for the upcoming 10 years.

Chairman NICKLES. Go ahead. Please proceed.

Mr. ANDERSON. I have a statement I would like to submit for the record, if that is approved by the Committee, but instead of reading that statement, I would like to summarize and address five points from it.

Chairman NICKLES. Mr. Anderson, can you give us 3 minutes? We will be right back. Good. Thank you. I apologize. We will be right back. [Recess.]

Chairman NICKLES. Mr. Anderson, I apologize, but now you can begin, and we won't be interrupted again.

Mr. ANDERSON. Thank you. As I said, I have a statement I would like to submit for the record, but I would like to summarize it briefly and emphasize five points.

First, as you have indicated, I have been in budgeting for quite some time, and have been doing budget and economic forecasts for some time, and am used to the kind of uncertainty that you alluded to and that is inherent in any kind of budget forecast.

With respect to the forecast we are making this year, I have to say that I do not believe I have ever encountered an economic forecast that is more uncertain. The reason for that is not the intrinsic uncertainties in the economy that are detailed in our report. Rather, it is the—as I call it—hippopotamus under the living room rug that nobody seems to be able to talk about, and that is the geopolitical risks.

As you may know, Mr. Chairman, we base a lot of our economic forecasts taking on what the private sector and our panel of economic advisors tell us. We try to listen carefully to them and not be significantly different in our forecast from the larger economic wisdom of private economic forecasters. We pay a lot of attention to the consensus of the *Blue Chip* economic forecasts.

What they assume with respect to the outcome of the current geopolitical situation is unknown. We have not built into our economic forecast the potential outcome of the current geopolitical situation we are facing, not just in the Middle East, not just in Asia, but also the terrorism aspects. The reason is that for all the uncertainties and problems you have just mentioned, those geopolitical outcomes are virtually impossible for us to predict.

We have looked at what others have said about the impact of the geopolitical situation on the economy and have tried to make estimates, but those other forecasts vary widely across the board. In addition, the possible geopolitical outcomes have impacts not just on direct spending for homeland security or national defense and not just on the price of oil but potentially on a much, much broader range of factors that includes the more important aspects of consumer and business confidence.

Therefore, we have a set of economic projections here that suffers from the same risks that previous economic projections have had to take into account, but on top of that, there is a level of geopolitical uncertainty that surronds CBO's forecast with more uncertainty, I think, than I have ever seen before.

My second point is that added to this level of geopolitical uncertainty, we also do not have—as you have correctly indicated, certain policy actions that the Congress and the President are actively debating as we speak. Those policy actions are very big and very important. They include not only defense spending, not only antiterrorism spending, but also increased spending on education, on health, on drug benefits, and various kinds of proposals on the tax side. As you have correctly pointed out, our projections do not take into account any potential new legislation. The impact of that new legislation could be large.

Having made those two points, I would like to just spend a few minutes on our baseline itself. Again, our baseline is not a forecast. It is a projection of what—under our assumptions about the economy and our pricing out of current law—the budget deficits and surpluses would be over the next 10 years. As the chart indicates, you can see that we have a projection of a $199 billion deficit in fiscal year 2003, dropping to $145 billion in fiscal year 2004, gradually declining after that, and then going to surpluses by 2007 (See Table 1). Those surpluses would increase into the out-years.

The point I would like to highlight from this, in addition to the uncertainties, is that as a percentage of Gross Domestic Product (GDP), virtually all of those numbers are quite small. To know the specific year in which we cross from deficit to surplus is much less important than to look at what the baseline says, under our economic assumptions, about how much of a deficit or surplus as a percentage of GDP we will have for the upcoming future. It is not the situation that I saw so much of in the 1990's and the 1980's, when we had significant deficits—significant not only in nominal amounts but as a percentage of GDP.

Instead, the numbers here—again, with no new legislation included—are very close to balance whichever year you take. About the only exception to that occurs way out in the out-years, in 2011, 2012, and 2013, when under current law the 2001 tax cut is scheduled to expire, and therefore, the amount of revenues coming in are projected to be significantly greater.

With those introductory comments, I have two other comments I would like to make before I end my short presentation. The comments revolve around the uncertainty of our budget projections.

Not only do we have significant uncertainty in the CBO baseline by design—that is, we explicitly do not make forecasts of what is going to happen in legislation—but we also have it in part because of the impossibility of accurately forecasting geopolitical outcomes. In addition, much uncertainty has to do with the fact that the U.S. economy and the Federal budget are highly complex and are affected by many economic and technical factors.

That uncertainty can be best illustrated by a fan of probabilities surrounding CBO's year-by-year point estimates, as indicated in this chart (See Figure 2). Not surprisingly, the range of those possible outcomes widens as the projection period extends farther out. The fan chart makes clear that outcomes quite different from the ones we have projected have a significant likelihood of occurring.

We can also use the fan chart methodology to examine whether CBO's projections are consistently biased in one direction or another. As the next chart indicates, CBO's missed estimates of the budget's bottom line do not appear to be systematically biased (See Figure 3). Sometimes the projections were too high and at other times, too low. For example, the 5-year budget calculations made between 1993 and 1997 tended to be too pessimistic, while most of the estimates made earlier tended to be too optimistic.

By the way, this chart presents only estimates through 1997 because we did not have actuals for the full 5-year period beginning in 1998. We also do not have a figure in here for 1982, because CBO did not produce a full 5-year projection at that time.

The same chart can also be looked at not only to see if there is some systematic bias but also to see if we can achieve greater estimating accuracy in our forecast.

In looking at recent criticisms of our methods, we undertook to do some calculations to see whether our baseline economic projections sufficiently accounted for the supply-side effects of changes to tax laws. The small fan charts show that increasing the assumed response of labor supply and investment—the feedback effects—would generally not have improved budget estimates made during periods in which there had been major changes to the tax system (See Figure 3).

For example, adding revenues to the baseline projections of the primary surplus—that is, the surplus excluding interest costs—for the mid-1980's to reflect larger supply-side effects from the Economic Recovery and Tax Act of 1981 would have increased rather than reduced the forecasting inaccuracies. Similarly, incorporating larger supply-side effects from the Omnibus Budget and Reconciliation Act of 1993 than those incorporated into subsequent baselines would have reduced the level of revenues and magnified the inaccuracies.

I am not saying, Mr. Chairman, that there are no supply-side effects. There are. CBO has regularly—does now and, in this document, continues to—estimate the supply side effects of fiscal changes in general and tax changes in particular. To do more than what we have done in the past according to this analysis, would not apparently have increased our accuracy.

The last point in my testimony is that given the uncertainty surrounding CBO's outlook and the current pressures on the budget, I thought it might be useful to say something about how our projections might be used in considering fiscal policy.

First, several factors argue for focusing on the long term. Just past the 10-year budget baseline loom significant long-term strains on the budget as the baby-boom generation ages. The number of people reaching retirement age will surge by about 80 percent in the next 30 years while the number of workers to pay for those benefits will increase only by 15 percent.

In addition, we know given the demographic situation, that the costs per enrollee for Federal health benefits are likely to grow much faster than inflation. As a result, the amount that the Government spends for major health and retirement programs 30 years from now is projected to consume a substantial portion of what the Federal Government currently spends for all its programs. Although the current baseline that I have just talked about leads to a brighter situation for the next few years, that picture is bound to change; and policy choices now would serve the Nation's fiscal health best if they could avoid making the long-term situation worse.

Today, with security and economic concerns paramount, the long-term perspective may seem elusive. The current debate seems to focus on desirable levels of taxes and spending and, correspondingly, the appropriate size of Government. This chart is a good way to keep in mind what that longer-term situation is, particularly over the next 10 years (See Figure 1).

It also helps present what I see as two contrasting viewpoints about how questions about future policies ought to be answered. One viewpoint advocates a more limited size of Government. Proponents of that viewpoint seek lower levels of taxation and lower levels of spending. CBO's estimates indicate that total revenues as a percentage pf GDP are now close to their historical level. As you can see, at our current levels of taxation, we are close to the average revenues we have had for the past 40 years—that is, about 18 percent or so. However, revenues as a share of GDP are projected to creep up to more than 19 percent by 2010 under current policies. If the tax cuts enacted in 2001 are allowed to expire in 2010, as is called for under current law, then by 2013, revenues as a percentage of GDP will climb to 20.6 percent—a level never reached before except during World War II and in 2000, and more than 2 percentage points above the 1962-to-2002 average.

Another viewpoint is to see a larger, more expensive role for Government. This viewpoint says that there are important and legitimate unmet needs that cannot be offset elsewhere by spending cuts and that require a higher level of taxation. CBO's baseline does not include the funding for those needs. If it did, spending as a percentage of GDP would move toward higher levels than those depicted in the figure—levels closer to the historical average shown there.

Boosting spending further to pay for education, homeland security, precription drug benefits for the elderly, and other needs, including, possibly, a war with Iraq, will require a level of revenues much above the historical average; and without the willingness or ability to cut other spending in order for deficits not to grow, taxes must go up.

So the outstanding question for the Congress seems to me to be, as it creates a budget for 2004 and future years, not the way this chart looks now but rather how it should look in the future. While some people feel that there may be some obvious, clear path to a higher standard of living for all Americans, I do not see the public policy choices that must be made as quite so clear.

Whatever the decisions that are made, it is critical, I think, to avoid a prolonged and unsustainable mismatch between taxes and spending. Cutting taxes and limiting spending growth is one alternative. Boosting spending and increasing taxes in order to support that spending is another.

In this context, I hope, Mr. Chairman, that CBO's baseline projections can be used to gauge the degree of latitude that the Congress has to adjust its priorities while preserving a budget that balances long-term economic growth and fiscal responsibility with unmet needs.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Barry Anderson follows:]

CBO TESTIMONY

Statement of
Barry B. Anderson
Acting Director

The Budget and Economic Outlook: Fiscal Years 2004-2013

before the
Committee on the Budget
United States Senate

January 30, 2003

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

Mr. Chairman, Senator Conrad, and Members of the Committee, I am pleased to be here today to discuss the Congressional Budget Office's (CBO's) baseline budget projections for 2003 through 2013. As it does each January, CBO has issued its outlook for the budget and the economy. The baseline budget projections that CBO provides incorporate the assumption that current laws and policies remain unchanged—thereby serving as a point of departure for measuring policy changes. The baseline also includes a variety of estimates and assumptions about how the economy will behave and government programs will operate. Such projections are always uncertain, but this year, the uncertainty is unusually pronounced.

Uncertainty in the Outlook

Before I discuss those projections, though, I would like to describe some of the uncertainty surrounding the baseline estimates. That uncertainty can be broken down into three main types: geopolitical, economic, and legislative. Unfortunately, many of the possible outcomes encompassed by that uncertainty are more likely to worsen than to improve the budget outlook.

Geopolitical Uncertainty

By far the biggest uncertainty is the potential instability in the international arena. A war with Iraq, for example, would require increased defense spending for supplies and other near-term needs as well as for the future replenishment of resources used in combat. Substantial resources might also be needed for reconstruction, occupation, and assistance to allies. In addition, such a war could have implications for oil prices (positive ones if the war went quickly and smoothly; negative ones if it took longer than expected and production was disrupted), which would ripple through the economy.

The ongoing threat of terrorism could also have budgetary implications. Shortly after the terrorist attacks of September 11, 2001, the Congress and the President enacted $40 billion in supplemental appropriations; another $25 billion was approved last summer. Concerns about homeland security and the implementation of measures to prevent future attacks will maintain the pressure to increase federal spending. And any additional terrorist attacks could threaten the economy's recovery.

Economic Uncertainty

Although uncertainty about the economy and about the effects of future legislation pales in comparison with the uncertainty surrounding geopolitical outcomes, both are clearly important and potentially very significant for the budget.

The economy continues to rebound from the recession of 2001. The future course of the recovery depends in large part on whether consumers will continue to provide the foundation for the economy's growth. Despite the three-year decline in the stock market, the household sector has been a source of strength throughout the recession and into the recovery. The growth of consumer spending is uncertain in the near term, however, because demand is weak in many other sectors of the economy. Spending by the business sector remains weak, as low corporate profits and excess capacity from overinvestment during the "bubble" years of the late 1990s have inhibited investment. Moreover, uncertainty about the strength of demand, and about the risks arising from terrorism and war, have led businesses to be particularly cautious in hiring. In addition, deteriorating state and local government finances have curtailed spending and may prompt some tax increases.

Nevertheless, some indications point to a brighter outlook for the economy as the year goes forward. Investors and consumers appear to have gained confidence in recent months, and the stock market has moved tentatively upward since its low in October. Spending by businesses on equipment and software, particularly on information technology, strengthened last year, and inventories may be reaching the point at which firms need to restock their shelves. Finally, the drop in the exchange value of the U.S. dollar sets the stage for stronger growth of exports.

Over the longer haul, the question of labor productivity looms large. From 1951 through 1973, the growth of gross domestic product (GDP) per worker—after adjusting for the business cycle—averaged about 2.2 percent a year. However, from 1974 through 1995, the growth of productivity slowed substantially, to a rate that was little more than half as fast. More recently, though, productivity growth picked up again, to about the same rate experienced during the high-growth period. That recent upturn has prompted CBO to remain upbeat about future productivity growth.

Legislative Uncertainty

CBO's baseline projections are intended to serve as a neutral benchmark against which to measure the effects of possible changes in tax and spending policies—they are not a forecast or prediction of future budgetary outcomes. Our projections are constructed according to both rules set forth in law and long-standing analytical practices and are designed to project federal revenues and spending under the assumption that current laws and policies remain unchanged. Thus, legislation enacted in the future by the Congress and the President will almost assuredly alter the bottom line.

Pressures to increase spending and reduce taxes could lead to a substantially worsened budgetary picture. For example, final appropriations for fiscal year 2003 could exceed the $751 billion that apparently has been agreed upon by the Republican leadership and the President, especially if supplemental appropriations were enacted later in the year. Other legislative action could also dim the outlook. Measures intended to stimulate the economy, fund military action and subsequent redevelopment in Iraq, extend expiring tax cuts, modify the alternative minimum tax, establish a prescription drug benefit for the elderly, or meet other pressing national needs could substantially increase projected deficits or reduce projected surpluses in the future.

The Budget Outlook

If current policies remained in place, the federal budget deficit would grow from $158 billion in 2002 to $199 billion in 2003, by CBO's projections (*see Table 1*). In nominal dollars, such a deficit would be the largest since 1994; however, at 1.9 percent of GDP, it would be well below the share of the economy that deficits accounted for in the 1980s through the mid-1990s.

Revenues in CBO's outlook are anticipated to resume their upward path in 2003 after falling in both 2001 and 2002. (The decrease in revenues from 2001 to 2002—nearly 7 percent—was the largest annual drop, in percentage terms, since 1946.) Total revenues are projected to grow to $1.9 trillion this year—about $68 billion (or 3.7 percent) above the amount recorded in 2002 but well below the $2.0 trillion that the government collected in the peak year of 2000. Much of that projected growth can be

Table 1.

The Budget Outlook Under CBO's Adjusted Baseline

(In billions of dollars)

	Actual 2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
On-Budget	-317	-361	-319	-268	-228	-205	-185	-165	-145	-26	134	177	-1,206	-1,231
Off-Budget[a]	160	162	174	195	212	231	250	268	286	303	317	330	1,063	2,568
Total Surplus or Deficit (-)	**-158**	**-199**	**-145**	**-73**	**-16**	**26**	**65**	**103**	**140**	**277**	**451**	**508**	**-143**	**1,336**
Total Surplus or Deficit (-) as a Percentage of GDP	-1.5	-1.9	-1.3	-0.6	-0.1	0.2	0.5	0.7	0.9	1.7	2.7	2.8	-0.2[b]	0.9[b]
Debt Held by the Public at the End of the Year	3,540	3,766	3,927	4,013	4,045	4,034	3,983	3,894	3,766	3,501	3,062	2,565	n.a.	n.a.
Debt Held by the Public at the End of the Year as a Percentage of GDP	34.3	35.0	34.7	33.6	32.2	30.4	28.5	26.5	24.3	21.5	18.0	14.4	n.a.	n.a.

Source: Congressional Budget Office.

Notes: These projections incorporate the assumption that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

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.
b. As a percentage of cumulative GDP over the period.

traced to the improved economic prospects that CBO forecasts for 2003. At 17.9 percent of GDP, estimated revenues for this year are roughly at the average for the 1962-2002 period (*see Figure 1*).

Outlays are expected to grow to over $2.1 trillion this year—a rise of $110 billion (or 5.5 percent) from 2002 (*see Table 2*). Although net interest costs are falling (because of low interest rates), spending for all of the government's other programs and activities is projected to grow by 6.7 percent. That rate of increase is well below the 11 percent growth of noninterest spending in 2002—but still greater than the 3 percent average growth during most of the 1990s.

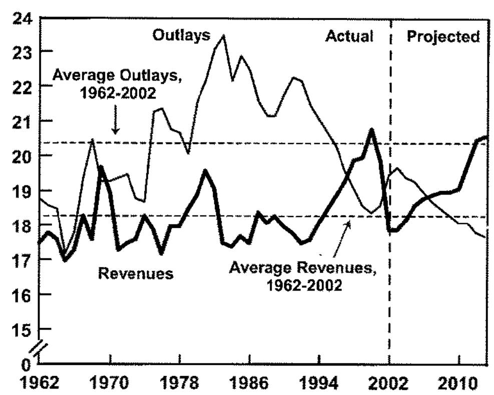
Fueling the rise in spending are boosts in discretionary outlays and continued growth of entitlements. Both defense discretionary spending (up by $28 billion from 2002) and nondefense discretionary spending (up by $30 billion) are expected to rise by nearly 8 percent this year. Those estimates are based on the assumption that discretionary budget authority for 2003 will total $751 billion. Both kinds of discretionary spending grew even faster in 2002 than the growth projected for 2003: defense outlays rose by 14 percent, and nondefense outlays, by 12.3 percent.

Spending for mandatory programs—which now consumes over half of all federal outlays—is estimated to increase in 2003 by $66 billion over its level in 2002. Social Security, Medicare, and Medicaid account for much of that jump. Total mandatory spending is projected to rise more slowly in 2003, at a rate of 6.0 percent, than it did in 2002—when it climbed by 9.6 percent. In particular, the rate of growth of Medicaid outlays is expected to drop from 13.2 percent in 2002 to 6.4 percent in 2003—

Figure 1.

Total Revenues and Outlays as a Share of GDP, 1962-2013

(Percentage of GDP)



Sources: Congressional Budget Office (projections); Office of Management and Budget (historical budget data).

Note: CBO's projections incorporate the assumption that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

as a result of slower growth in enrollment, smaller increases in payment rates, and restrictions on certain types of spending.

Declining interest payments will offset some of the increases in discretionary and mandatory outlays. Despite a rise in debt held by the public, low interest rates in 2003 are projected to reduce net interest payments by $14 billion (or 8.1 percent).

CBO projects that the deficit will fall to $145 billion (1.3 percent of GDP) in 2004. Revenues are anticipated to climb to 18.2 percent of GDP as economic recovery progresses. Outlays as a share of the economy, however, are projected to fall from 19.7 percent of GDP in 2003 to 19.4 percent in 2004.

Over the full 10-year budget period (2004 through 2013), revenues under baseline assumptions are estimated to grow faster than outlays. CBO projects that revenues will grow at an average annual rate of 6.3 percent through 2010—increasing from 17.9 percent of GDP in 2003 to 19.1 percent in 2010. That increase occurs principally because of the tendency of the progressive U.S. tax system, as real income grows, to increase the proportion of income that it collects in taxes. After 2010, that tendency is exacerbated by the scheduled expiration of the tax cuts enacted in 2001.

Table 2.

Average Annual Rate of Growth in Outlays Under CBO's Adjusted Baseline

(In percent)

	Actual 2001-2002	Estimated 2002-2003	Projected[a] 2003-2013
Discretionary Spending	13.1	7.8	2.6
Defense	14.0	7.9	2.7
Nondefense	12.3	7.7	2.4
Mandatory Spending	9.6	6.0	5.4
Social Security	5.4	4.8	5.5
Medicare[b]	6.4	5.7	6.6
Medicaid	13.2	6.4	8.5
Other[b]	18.5	7.9	2.1
Net Interest	-17.1	-8.1	0.1
Total Outlays	7.9	5.5	4.1
Total Outlays Excluding Net Interest	11.0	6.7	4.4
Memorandum:			
Consumer Price Index	1.5	2.3	2.4
Nominal GDP	3.0	4.1	5.2
Discretionary Budget Authority	10.7	2.2	2.8
Defense	8.8	5.8	2.7
Nondefense	12.6	-1.3	2.8

Source: Congressional Budget Office.

Note: The projections incorporate the assumption that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

a. As specified by the Deficit Control Act, CBO's baseline uses the employment cost index for wages and salaries to inflate discretionary spending related to federal personnel and the GDP deflator to adjust other spending.

b. Includes offsetting receipts.

In contrast to the rise in revenues relative to GDP, the growth of total outlays under baseline assumptions would remain below the pace of growth of the economy. Mandatory spending—led by Medicare and Medicaid—is expected to grow slightly faster than the economy (at an average annual rate of 5.4 percent, compared with projected growth in nominal GDP of 5.2 percent). But discretionary spending in CBO's projections is assumed to rise only by the rate of inflation (an assumption specified in the Balanced Budget and Emergency Deficit Control Act of 1985), or about half as fast as nominal GDP. And interest payments—with debt held by the public growing slowly in the near term and shrinking in later years—are estimated to decline from 1.5 percent of GDP in 2003 to 0.9 percent in 2013.

For the five years from 2004 through 2008, CBO projects that if current policies remained unchanged (and the economy followed the path of CBO's projections), deficits would diminish and surpluses would reappear, leaving the budget roughly balanced. Over the 2004-2008 period, the cumulative deficit would total $143 billion—or 0.2 percent of GDP, by CBO's estimates.

Table 3.

CBO's Economic Forecast for Calendar Years 2003 and 2004

	Estimated 2002	Forecast 2003	2004
Nominal GDP (Percentage change)	3.6	4.2	5.4
Real GDP (Percentage change)	2.4	2.5	3.6
Consumer Price Index (Percentage change)[a]	1.6	2.3	2.2
Unemployment Rate (Percent)	5.8	5.9	5.7
Three-Month Treasury Bill Rate (Percent)	1.6	1.4	3.5
Ten-Year Treasury Note Rate (Percent)	4.6	4.4	5.2

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

a. The consumer price index for all urban consumers.

For the 10-year period from 2004 through 2013, the cumulative surplus is projected to total $1.3 trillion. But the last three years of the period are almost entirely responsible for that total. Projected surpluses from 2011 through 2013—the years after the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) is scheduled to expire—account for nearly 93 percent of the 10-year sum. (CBO estimates that if EGTRRA is not extended, revenues will climb to more than 20.5 percent of GDP—a level previously seen only during World War II and in 2000.) Through 2010, the baseline budget is projected to be close to balance, with annual deficits and surpluses generally running at 1 percent or less of GDP.

The Economic Outlook

CBO expects that the slow economic recovery will continue, with real (inflation-adjusted) GDP growing by 2.5 percent in calendar year 2003 and 3.6 percent in 2004 (*see Table 3*). That growth is comparable to the pace following the 1990-1991 recession. The unemployment rate is expected to stabilize in 2003 at 5.9 percent and then edge down to 5.7 percent in 2004. As the recovery achieves a firmer footing, CBO assumes that the Federal Reserve will gradually shift monetary policy from its current accommodative stance toward a more neutral one; consequently, both short- and long-term interest rates are expected to rise in late 2003 and during 2004. In CBO's current forecast, the consumer price index (CPI) remains below 2.5 percent for the next two years.

For the period from 2005 through 2013, CBO estimates that real GDP will grow at an average annual rate of 3.0 percent. CBO's projections for unemployment, interest rates, and inflation during that period are quite similar to the ones it published last August. Thus, CBO projects that the unemployment rate will decline to 5.2 percent (which equals its estimate of the nonaccelerating inflation rate of unemployment); the interest rate on three-month Treasury bills will reach 4.9 percent; the 10-year note rate will average 5.8 percent; and CPI inflation will average 2.5 percent annually.

Uncertainty of Budget Projections

As discussed earlier, significant uncertainty surrounds CBO's baseline projections, partly by design—CBO's baseline does not take into account potential legislative changes—and partly because of the impossibility of accurately forecasting future geopolitical outcomes.

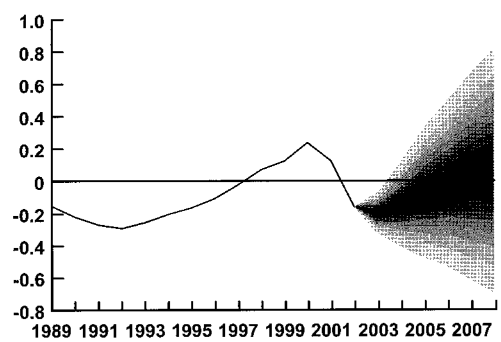
In addition, much uncertainty stems from the fact that the U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to foresee. That uncertainty can best be illustrated by a fan of probabilities surrounding the year-by-year point estimates presented in this testimony (*see Figure 2*). Not surprisingly, the range of possible outcomes widens as the projection period extends. The fan chart makes clear that outcomes quite different from those in our baseline have a significant likelihood of occurring.

We can also use the fan chart methodology to examine whether CBO's projections have been consistently biased in one direction or the other (*see Figure 3*). As the figure shows, CBO's misestimates

Figure 2.

Uncertainty of CBO's Projections of the Total Budget Surplus Under Current Policies

(In trillions of dollars)



Source: Congressional Budget Office.

Note: Calculated on the basis of CBO's track record, this figure shows the estimated likelihood of alternative projections of the surplus under current policies. CBO's projections fall in the middle of the darkest area. Under the assumption that tax and spending policies do not change, the probability is 10 percent that actual surpluses or deficits will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

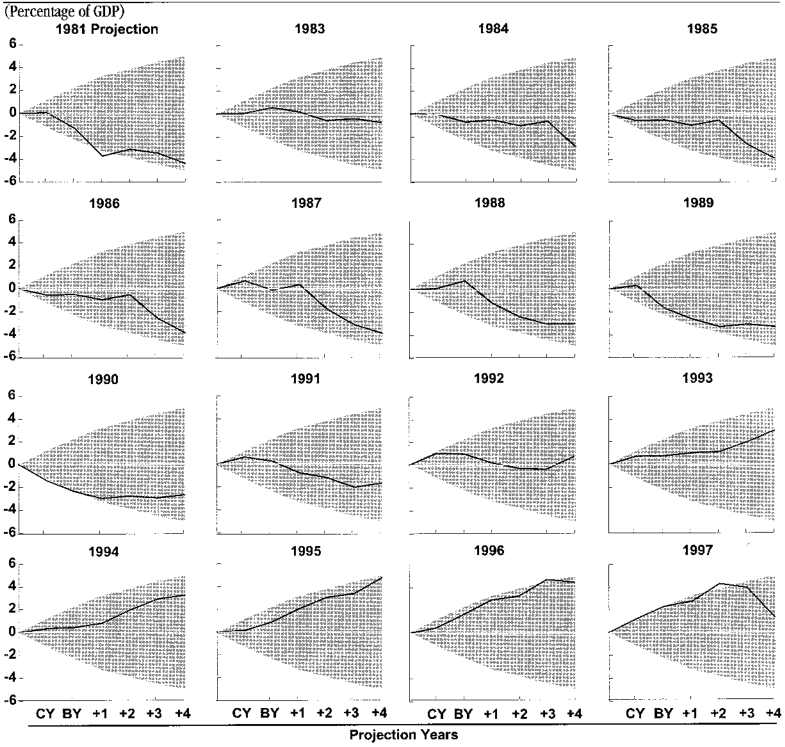
Actual surpluses or deficits will of course be affected by legislation enacted during the next 10 years, including decisions about discretionary spending. The effects of future legislation are not included in this figure.

For an explanation of how CBO calculates the probability distribution, see *Uncertainties in Projecting Budget Surpluses: A Discussion of Data and Methods* (February 2002), available at www.cbo.gov; an update of that publication will appear shortly.

Figure 3.

Misestimates in CBO's Projections Made from 1981 to 1997

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: CY = current year; BY = budget year.

This figure shows misestimates in CBO's projections of the primary surplus—the total surplus excluding net interest—made at different times. Plotted points that lie below the center line reflect instances in which CBO overestimated the primary surplus, while points above the center line reflect underestimates. In each panel, the shaded cone indicates the estimated 90 percent confidence band; that is, there was a 90 percent chance that CBO's projection would be within the shaded area. CBO estimated that confidence band on the basis of its track record since 1981 (excluding 1982, because of insufficient data).

The figure excludes the effects of legislation enacted after the projections were made.

of the budget's bottom line do not appear to be systematically biased: sometimes the projections were too high and at other times too low. For example, the five-year budget calculations made between 1993 and 1997 tended to be too pessimistic, while most of those made earlier tended to be optimistic. Not enough time has elapsed since our more recent projections for us to be able to comment on their accuracy.

Accuracy of CBO's Estimating Methodology

Over time, CBO has constantly changed (and, one hopes, improved) its estimating methodology to achieve greater accuracy in its projections. In looking at recent criticisms of our methods, we undertook some calculations to shed light on the issue of whether our baseline economic projections sufficiently accounted for the supply-side effects of changes in tax law. Thus, the small fan charts also show that increasing the assumed response of labor supply and investment to changes in taxes (and their "feedback effects" on the budget) would generally not have improved budget estimates made during periods in which the tax system was undergoing significant change. For example, adding revenues to the baseline projections of the primary surplus (the surplus excluding interest costs) for the mid-1980s to reflect larger supply-side effects in those baselines from the Economic Recovery Tax Act of 1981 would generally have increased rather than reduced the forecasts' inaccuracies. Similarly, assuming larger supply-side effects from the Omnibus Budget and Reconciliation Act of 1993 than those incorporated into subsequent baselines would have reduced the level of estimated revenues and magnified the inaccuracies in projecting the budget balance in subsequent years. We continue to pursue improved accuracy and will seek additional input from outside experts on a variety of methodological issues.

Context for the Future

Given the uncertainty surrounding CBO's outlook and the current pressures on the budget, I thought it might be useful to say something about how our projections might be used in considering fiscal policy.

First, several factors argue for focusing on the longer term. Just past the 10-year baseline period loom significant long-term strains on the budget that intensify as the baby-boom generation ages. The number of people of retirement age will surge by about 80 percent over the next 30 years—increasing costs for federal benefit programs—while the number of workers whose taxes help pay for those benefits is expected to grow by only 15 percent. In addition to the demographic situation, the costs per enrollee in federal health care programs are likely to grow much faster than inflation. As a result, the amount that the government spends on its major health and retirement programs (Medicare, Medicaid, and Social Security) is projected to consume a substantial portion of what the government now spends on the entire budget. Although the current baseline shows a brighter situation a few years out, that picture is bound to change, and the policy choices made now serve the nation's fiscal health best if they avoid making the long-term situation worse.

Today, with security and economic concerns paramount, that long-term perspective may seem elusive. The current debate seems to focus on the desirable levels of taxes and spending and, correspondingly, the appropriate size of government. However, the way in which those questions are resolved will inevitably influence the long-term budget situation. The illustration of historical revenues and outlays and CBO's baseline projections for the next 10 years can help depict two contrasting viewpoints about how those questions should be answered *(see Figure 1 on page 4)*.

Many policymakers advocate a more limited sized government. Proponents of that view seek lower taxes and lower levels of spending. CBO's estimates indicate that total revenues are now close to their historical level (around 18 percent of GDP). However, revenues as a share of GDP are projected to creep up to more than 19 percent in 2010 under current policies. If the tax cuts enacted in 2001 expire in 2010 as scheduled, total revenues in 2013 are projected to reach 20.6 percent of GDP—over 2 percentage points above the average from 1962 through 2002.

Other policymakers see a more expansive role for government. They believe that the country has significant unmet needs whose costs cannot be offset elsewhere with spending cuts and that therefore require higher levels of taxation. CBO's baseline does not include funding for such unmet needs; if it did, spending as a percentage of GDP would move toward higher levels than those depicted in the figure—levels closer to the historical average. Boosting spending further to pay for education, homeland security, a prescription drug program for the elderly, or other needs (not to mention a possible war with Iraq) may well require a level of revenues above the historical average. Without a hike in revenues, and without the ability to offset such spending in other parts of the budget, large deficits would return.

So, the outstanding question for the Congress as it creates budgets for 2004 and future years is not how the aforementioned figure looks today but how it should look in the future. While some people may feel that there is an obvious, clear path to a higher standard of living for all Americans, the public policy choices that must be made along the way are not as clear. But whatever decisions are made, it is critical to avoid a prolonged and unsustainable mismatch between taxes and spending. Cut taxes—but limit spending as well. Alternatively, boost spending—but increase revenues to the levels necessary to support that spending. In that context, CBO's baseline projections can be used to gauge the degree of latitude that the Congress has to adjust priorities while preserving a budget that balances long-term economic growth and fiscal responsibility with current needs.

Chairman NICKLES. Mr. Anderson, thank you very much. We appreciate your presentation before the Committee and welcome your input, and we will ask you a few questions.

Before I do that, I notice my colleague and former chairman of the Committee arrived, and I wished to mention this yesterday but we missed each other in the Committee. I wanted to compliment him for his many years of service on this committee—I believe going back to 1975?

Senator DOMENICI. Right.

Chairman NICKLES. That is remarkable. You also chaired it or was ranking member, I believe, for about——

Senator DOMENICI. Seventeen years.

Chairman NICKLES. Seventeen of those years. Senator Conrad and I would say that that is not an easy challenge, and you handled yourself very well, both as chairman and as ranking member.

Senator DOMENICI. Thank you.

Chairman NICKLES. Passed a resolution every year, and I compliment you for your service. I am delighted that you are still on this committee and would welcome any opening comments that you wish to make.

Senator DOMENICI. Well, thank you very much, Mr. Chairman. It is good to be here. I heard a little bit but not enough to be totally familiar with the words of wisdom you have given us, but I would like to say before I make a few observations, Mr. Chairman, that, one, I compliment you based on what I have seen about your attitude about the Committee. I think it is marvelous that you are enthusiastic and that you want to broaden the scope of the hearings and activities of the Committee. I think that will be welcome. The committee has broad jurisdiction in that regard, and if the Committee members want to join you, that would be a very exciting approach for the Committee.

In addition, as I have told Senator Nickles heretofore, for better or for worse, the Committee has a legacy from those 17 years of expanded power beyond which those who wrote the Budget Act envisioned. Clearly, the scope and capacity to mandate change through reconciliation is a rather fantastic power, and it has been used so often that I believe it is now without challenge. Of course, the challenge can be made as to what to use it for, but not to its use. In addition, the concept of reserve funds that are released at the Chairman's call, if the Senate complies with what the Committee said, it is indeed a very vital tool which you will find exciting as you attempt to use the Committee for more than just a resolution that perhaps in some instances would not even be complied with.

So I think that is a good result. I am very hopeful that sometime we will be able to document the impact of that on the Senate. I would think a small textbook about the impact of the Budget Act in 25 years on the procedures and processes of the U.S. Senate might indeed be a welcome document. It will show that Senator Robert Byrd, the beloved spokesman for open debate and filibusters, helped write a bill that clearly whacked filibusters to the bone. They are not available in anything that has to do with the budget, neither reconciliation, neither budget resolution, neither amendments. I am sure that if it we reconsidered, that is, the

Budget Act, people would wonder whether it would pass in that way, Mr. Chairman, again.

I have had a chance to review as much as I usually do, even when I was chairman, the economic outlook, and I understand it is very uncertain. I do understand that the world is uncertain. It is not just the policies of the Federal Government in budgetary matters that are uncertain. I am a bit concerned. I see the deficit as being manageable, and I see your projections for the next 10 years of the deficit as being manageable. However, you have not put into your projections what we might do. Your projections, so everybody understands, are what we have already done. You don't have in these projections what Senator Nickles and this committee might say we are going to do in taxes. It doesn't have what we are going to do in expenditures in excess of this baseline or less than, or in new entitlement programs that are not in your baseline.

Hopefully, when they finish their work, they will ask somebody to adjust the baseline, but you start with yours. That is a good working arrangement, Mr. Chairman.

Also, it would appear to me that 10 years out of 10 years of debt, accumulation of deficit is workable. I would be interested what the debt-to-GDP ratio might be at 20 years or 30 years or 40 years, with just a few things put in it, assuming Medicare and assuming Social Security and perhaps a few other benefits of significance are put into it. It would be interesting to see the debt—debt, not deficit-to-GDP ratio. Could you tell us just in summary what is the debt-to-GDP ratio now and what will it be in 10 years?

Mr. ANDERSON. It is about 35 percent now. Under our baseline, I believe it declines to 14 percent. Two years ago, we did a study of the debt-to-GDP ratio under a variety of different long-term scenarios. The operative word from that is "explosive"; that is, with the growth that one can see of the baby boomers retiring for Social Security, Medicare, and Medicaid, one can see an explosive result in debt to GDP.

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

Thank you, Mr. Chairman. It is good to be with you.

Chairman NICKLES. Well, it is good to have you back, Senator Domenici, and, again, I thank you for your service and look forward to working with you continually on this committee and on the Energy Committee, of which you are now chairman. I think you will do a fantastic job in that capacity as well.

I am going to call upon our colleagues in order of appearance. I would like to recognize the ranking member, but before I do, I want to just say I always want these meetings to be congenial, as I stated earlier, you are entitled to your opinion, not your facts. I say that all the time. We might have a little difference of opinion on some things, and one of the questions I think I would ask you, Mr. Anderson, is: Where did the $5.6 trillion surplus go? Or where did the $313 billion surplus that you projected in 2002 or the $350 billion surplus that you projected in 2003—how that differed? If you would, just give us a little piece of paper. You don't have to do it today. You can do it today if you so desire. How much of your revenue estimates were missed? How much of it was technical and economic? How much of it because of the tax changes we made? How much because the spending exceeded estimates? If you have that, you can submit it for the record. If not, I just wanted to mention to my colleagues, we are going to have a lot of hearings, but I will try to always stick to the facts and never impugn anybody's motives in any way, shape, or form.

If you have that information, you can give it to us, or——

Mr. ANDERSON. Let me just answer very briefly. As was mentioned, I was here 2 years ago and was at that time the official representative of CBO's forecast of the $5.6 trillion surplus. I hope that the forecast I am presenting now turns out to be much more accurate than the one that we presented then.

Let me also point out that that $5.6 trillion projection covered the years 2002 through 2011. We are in 2003 now. We still have quite a few years to go on that. Yes, our projections have changed dramatically. I personally hope—and I am sure you all do too—that they will change dramatically again but in the opposite direction; that we will see a much greater increase in economic growth than the growth we have seen in the past 2 years.

Looking at what has happened in 2002 and then looking at the revision for the projections for 2003 through 2011 relative to the $5.6 trillion, we have seen, as was indicated previously, that $5.6 trillion surplus now go to a cumulative baseline surplus of $20 billion for the 2002–2011 period.

Where did that $5.6 trillion go? Well, first of all, economic and technical changes accounted for well over $2.5 trillion of the reduction, or about 46 percent. Let me emphasize that I said economic *and* technical. The line between those two isn't nearly as distinct as it appears in our documents, with specific numbers for each kind of change. It is very much a subjective process to decide how much of a change is economic and how much is technical and how much interaction there is between the two. Therefore, I like to lump them together when looking at it.

We missed for sure. We missed on the economy. We missed the technical interactions of the economy with the budget, and that constituted about 46 percent of the decline in the projected surplus.

The remaining 54 percent is from legislation, and I think it is important to break that legislation into three components. The first is the Economic Growth and Tax Relief Reconciliation Act of 2001, which accounted for about 23 percent. The second is increased discretionary spending, which was about 18 percent. The remainder reflectsis a few smaller bills and debt service on the rest.

My point is, it wasn't the tax cut and it wasn't spending. It was, first, the economy and, then, a combination of the tax cut and spending. That took us from $5.6 trillion down to $20 billion.

Chairman NICKLES. Can I just ask you a question?

Mr. ANDERSON. Sure.

Chairman NICKLES. This is on my time now. I will turn it over to my colleague, but you are answering some of the questions. I happen to concur. The figures I have showed that, yes, the technical re-estimates, 46 percent. I show tax cuts of 21 percent on the bipartisan but also the bipartisan economic stimulus being another 1 percent, so tax cuts being 22. On spending, I show discretionary at 15 percent and mandatory at 17 percent for a combined spending increase of 32 percent.

Mr. ANDERSON. The figures you have I believe are accurate, but the mandatory total includes debt service.

Chairman NICKLES. I think that is correct.

Mr. ANDERSON. Then I think everything balances out.

Chairman NICKLES. I appreciate that. I would also like the breakdown for 2002 and 2003, and you don't have to give that to us today, but I would just like it. I think it would be good for the record.

You missed big time and everybody else did, so I want to continue repeating that. I am not throwing stones. I am just trying to maybe help us get to where we are more accurate. It was a very difficult time to estimate. I did show the chart on Nasdaq collapsing in 2000, and I don't think it was plugged in correctly on those losses and how they would go through, whether that is reduction in capital gains, which I remember yesterday we pulled out a chart that showed capital gains income went from $119 billion to 50-some, maybe 70 and then 50-some.

Anyway, I think we are pretty close, and basically if you could give us year by year, but I think it shows that economic and technicals were $308 billion of the difference in 2002. That is way off. That is way off. I told my friend and colleague, I said—and we are debating whether to do a 5-year or 10-year budget. We missed it so badly in the first 2 years. You know, we all need to do better, and maybe if we don't have an unpredictable event, we will be much closer.

On the revenue side, like I mentioned before, you were very close to being right on the money on outlays. You have been for years. Outlays, the estimates are very close. The revenues, because there was unprecedented decline or reduction in revenues of 7 percent last year, we all missed it big time. So I just mention that.

It is a pleasure to call upon my colleague and friend, Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Let me just revisit this question of where the money went.

Mr. ANDERSON. Sure.

Senator CONRAD. Because the calculations you have just done leave out significant items that are included in the chart that I showed. The chart that I showed, let me just put that back up. It showed that the disappearance of the surplus from 2002 to 2011, we included the President's proposals; that is, we are not talking about your baseline, which you are precluded from taking into account what the President has proposed going forward. You have to do just what has happened so far. So, of course, that leaves out the President's proposed making the tax cuts permanent, does it not?

Mr. ANDERSON. Our projection clearly does. It is based on current law.

Senator CONRAD. Yes. You don't have that included, and that is because you are presenting what is in current law. You don't have the President's growth package included in your calculation; isn't that correct?

Mr. ANDERSON. Correct.

Senator CONRAD. In addition, you show the associated interest costs with the loss of that revenue on the spending side.

Mr. ANDERSON. I tried to differentiate debt service when separating out three categories: taxes, spending, and additional costs.

Senator CONRAD. Right. I would attribute it to the tax cut. You are losing—you have additional interest costs because of the tax cut. When you do that calculation and you look at the $5.6 trillion, we adopt the President's policies, we are $1.6 trillion in the hole. That is over a $7 trillion swing. Where did it go? Thirty-nine percent of it is the tax cuts, both that have been made and that the President proposes, and the associated interest costs. Twenty-six percent are the technical changes. Much of it is the revenue not coming in as anticipated, quite apart from the tax cut. Spending, 25 percent, most of that defense and homeland security; 10 percent economic downturn.

So, Senator Nickles, I am not trying to have my own set of facts here. I am trying to do an honest determination of where the money went and where it is going. What accounts for this dramatic turnabout? I honestly believe the presentation that I have made is an accurate assessment of that. It takes into account not only what has happened but what the President proposes. It includes the associated interest costs.

Now, let me go to—you put up a fan chart, Mr. Anderson, which I commend you for showing because I think it is very important to understand how wide the swing can be here. Let's look back at what CBO showed in a fan chart back in 2001 and where we have actually come out. This is the range of estimates in the fan chart from low to high 2 years ago, and now we put in where we actually are. We are below the low end.

I can remember so well people telling me when I raised doubts about the size of the tax cut, that that was going to put us in jeopardy of going back into deficits and debt, so many people told me, Kent, you are being overly cautious. There is going to be more money than the top end of the projection because of the dynamic effect of the tax cut. We will have even more revenue. The head of the Office of Management and Budget of the President of the United States said there was going to be more revenue. He said that in testimony before this committee. He said maybe much more.

Well, he was wrong. He was wrong. Those of us who warned repeatedly that we were headed into a risky circumstance when we are betting on a 10-year forecast unfortunately have been proven all too right. I think, you know, past is prologue. Now we have a question of what we do going forward.

I think the Chairman is right to say we have to focus on what is going to improve economic growth, what is going to help us with this long-term circumstance. In addition to that, I believe we have to be very mindful of where this is all headed.

Mr. Anderson, you talked about explosive growth of debt as we head into the time of the baby boomers. Let me just put up the chart that I ended with before that shows what is happening to the trust funds. Let's put up that. Medicare Trust Fund, we are in the sweet spot of the cycle, and when this thing turns, it turns big time. Yet the President is proposing at that time a tax cut package now that will cost $4 trillion then. It doesn't add up. It doesn't add up. It is going to be a very deep hole for this country.

When you say explosive growth of debt, you are referring to, I take it, the effect primarily of the retirement of the baby-boom generation.

Mr. ANDERSON. Right.

The CHAIRMAN. Senator Conrad, are you—do you have a response?

Mr. ANDERSON. A couple of things. First of all, with respect to the numbers you mentioned, we will provide for the record the numbers you need for comparing the projections of 2 years ago with what actually happened and what the impact has been for 2002, 2003, and for the current 10-year projection period.

Chairman NICKLES. I appreciate that. We thank you.

Mr. ANDERSON. Second, my long career has been in budgeting. I am not an economist, and I am not an economic forecaster. In working with economists and economic forecasters, I believe that they have their most difficult time making forecasts when there is a change—a fundamental change. That is one of the things that was so pronounced in the past 2 years—that is, that we had a change from a fundamental rate of powerful economic growth to a rate that led us into a recession. As was pointed out, we didn't catch it. The Office of Management and Budget (OMB) didn't see it. Neither did anybody else.

The last thing I would point out is that we have also looked at the fan chart and at where we came out with respect to those projections. We do that without having policy changes in there—which I think your chart has—because we don't project policy changes in the baseline. Nevertheless, I also don't wish to dispute the point that, even taking out the policy changes, we are barely at the bottom line of the fan anyway.

Senator CONRAD. If I could just make a point on that? I don't want to leave the impression that I was being critical of CBO.

Chairman NICKLES. No, I know you weren't.

Senator CONRAD. I wasn't being critical of you showing the fan chart. I was trying to show where we are in the real world compared to the estimates of where we might be. You know, it is pretty stunning, and I think it has got to sober us all with respect to what we do going forward.

Chairman NICKLES. Senator Conrad, I echo that. I think I said the same thing. Nothing critical, Dr. Anderson, of you or even your cohorts. We just all missed the numbers big time, particularly 2 years ago. We didn't know about the terrorists, and we didn't know what happened in the market. I think there was a lot of negatives there that have flowed up, and the reason why revenues were down $175 billion from 2 years ago, that has hurt us big time.

Next we will call on Senator Crapo.

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

Mr. Anderson, I just have a question at the outset with regard to the first chart you showed called the budget outlook where you projected potential surplus and deficit over the next 10 years. As I understood your testimony and that chart, we see a significant increase in revenues in the out-years, primarily as a result of the expiration of the Tax Act of 2001; is that correct?

Mr. ANDERSON. Starting in 2011, that is correct.

Senator CRAPO. I realize it is not what you do in terms of you have to focus on current law, and currently that law is projected to expire. Have you done any projections as to what chart would look like if we assume that the Tax Act is continued and not allowed to expire?

Mr. ANDERSON. Yes.

Senator CRAPO. Well, first of all, I would like to ask if you would make those charts available. Second, what does that tell us if we make the assumption that the tax cuts are made permanent?

Mr. ANDERSON. If the tax cuts are made permanent, the surpluses in the out-years are not eliminated, but they are greatly reduced.

Senator CRAPO. There are still surpluses?

Mr. ANDERSON. There are still surpluses, small surpluses, in the out-years. One of the points I made is that in this time period, from 2004 to 2013, as a percentage of GDP, deficits or surpluses are relatively small. They don't really climb to a significant level until one reaches 2011, 2012, and 2013.

If one extended the tax cuts in 2011, 2012, and 2013, you would still have surpluses, but as a percentage of GDP, they would be very, very small.

Senator CRAPO. All right. Thank you. I want to focus now on the spending side of the equation for the next budget year, and as I understand your testimony—well, actually, let's look back at the current year for a moment. If I understand your testimony correctly, outlays grew by about 8 percent in 2003; is that correct?

Mr. ANDERSON. Correct.

Senator CRAPO. Do you know how that is broken out among mandatory spending versus discretionary?

Mr. ANDERSON. It is in our document here; *The Budget and Economic Outlook: Fiscal Years 2004-2013*. I will tell you what it is in just a second.

Senator CRAPO. All right. Well, the question I have is—and, again, looking at your testimony, it appears that you are projecting a 5.5 percent increase in outlays for this coming budget year. Do I read that correctly?

Mr. ANDERSON. That is correct. I believe that is correct.

Senator CRAPO. Well, again, I will kind of read from some of the statistics I get here, and you can correct me if I am reading them wrong. I understand that you are taking into consideration net interest costs falling during that period, but if you take out the interest factor, the actual increase in outlays is about 6.7 percent for the coming year.

Mr. ANDERSON. I believe that is correct.

Senator CRAPO. The growth in the economy, do you know what we expect the economy's growth to be?

Mr. ANDERSON. For calendar year 2003, 2.5 percent.

Senator CRAPO. So what you are projecting is that Congress is going to be outspending the growth in the economy by more than double in the coming budget year.

Mr. ANDERSON. I think it is 2.5 for 2003, and I think the figures you are quoting were between 2003 and 2004.

Senator CRAPO. Oh, OK.

Mr. ANDERSON. It is 3.6 for 2004.

Senator CRAPO. OK. So somewhere——

Mr. ANDERSON. Yes, right.

Senator CRAPO [continuing]. In the neighborhood of about a double of the economy.

Mr. ANDERSON. Right.

Senator CRAPO. Can you tell me what is fueling the rise in spending there in your projections?

Mr. ANDERSON. It is entirely in the entitlement area; that is, discretionary spending is growing at about or a little bit lower than the rate of the economy. In the entitlement area, particularly in the health area, Medicare and Medicaid and other Federal health benefits are increasing at rates significantly greater than the size of the economy.

Senator CRAPO. So if we are concerned about the rate of growth of spending on the spending side of the budget, it is the entitlement area, and particularly the health care area of entitlements, that we must focus on.

Mr. ANDERSON. It is; however, our baseline for discretionary spending assumes current law, which is right now at about a $750 billion budget authority level for 2003 and then just inflation. As we have talked about before, we don't have estimates in there for a war or additional anti-terrorism expenditures or whatever new discretionary expenditures may come out. Under that scenario you are exactly right.

Senator CRAPO. So what you are telling me is that under the Budget Act, you are required to assume that discretionary spending remains stable?

Mr. ANDERSON. At inflation, that is correct.

Senator CRAPO. At inflation.

Mr. ANDERSON. Right.

Senator CRAPO. Regardless of what you would see with regard to congressional actions, and I understand that.

If I could just ask one more question, I know that you have previously been asked about the potential cost of a war and that you have provided that information to the Budget Committee before. Could you briefly tell us whether you have any evaluations as to what the potential cost of a war with Iraq would entail?

Mr. ANDERSON. In late September, we did some estimates and broke them out in several different categories. The categories we broke them out into was the cost to get the men and materials and troops and ships over to the Middle East, so the deployment costs. Then we had a cost per month for combat, particularly the cost for the first month and for subsequent months. Then we had a cost for redeployment to take our materials and men back. Then we broke all that down by whether one looks at what we call the heavy air where we had much more concentration on an air conflict versus a heavy ground conflict. What we didn't do was say how many months the conflict was going to last.

Senator CRAPO. So you have broken it out on a monthly cost basis?

Mr. ANDERSON. On a monthly basis. After we did all that, then we also took a look at some historical occupation costs and gave figures on a monthly cost there. So I have these figures here, but the purpose of them was to take a look at past figures and our current knowledge and provide you with the information so that if you make a judgment of how long you think the war is going to last and how long the occupation was going to last, then you would have some broad senses of what the cost would be.

Senator CRAPO. I know we have those numbers, but if you could submit those again, I would appreciate that.

I believe my time has expired.

Chairman NICKLES. Senator Crapo, thank you very much.

Next we will call on Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

Just to follow-up with Senator Crapo's comments regarding the costs of war and Department of Defense, Homeland Security, and so on, you had indicated that economic change, slowdown, coupled with the tax cut passed last time and spending amount for these swings or changes and the loss of the surplus and so on, and I would just to my colleagues urge us to take a look at history when we are in time of war. We saw in the 1960's and early 1970's a buildup in military spending because of Vietnam and large deficits accumulate. In the 1980's, we saw large supply side tax cuts and, again, a large military buildup in the 1980's. The result was a tripling of the national debt and an explosion in interest rates.

I now see—and we are all talking about being at the brink of war, major war, possibly, with Iraq and homeland security, coupled with other costs that we have that relate to the ongoing war on terrorism. I would just first indicate that I would hope we would look to history and what has happened in the past when those items collide. We know, in fact, that on the discretionary side the largest increases are in defense and homeland security, and we all support those efforts to make sure that we are providing safety and security. Those are the kinds of spending increases that we are seeing, and we are going to see increased pressure in those areas. Wouldn't you agree—

Mr. ANDERSON. I agree, and the history aspects, particularly for military history and the costs involved, I think are important for whenever we consider a future military action.

Senator STABENOW. Concerning your comments regarding the uncertainties—and we certainly are in a time of credible uncertainty, geopolitical as well as economic, and I wouldn't want to be in your shoes or those of CBO trying to figure this out in the time of great uncertainty that we have.

In looking at your comments, I noted that your comments on economic uncertainty and where that comes from are different from what we heard yesterday, in part, from economists saying it wasn't about demand. You are putting forth another view that the growth of consumer spending is uncertain in the near term; however, because demand is weak—we have heard this certainly in many places. Demand is weak in many sectors of the economy; spending by the business sector remains weak as low corporate profits and excess capacity from overinvestment during the bubble years of the 1990's have inhibited investment. So we have an excess capacity problem which would say we need to increase demand. It is not a question of increasing supply. It is a question of increasing demand so we can bring down that overcapacity. At least that is how I would read it from what you are saying.

Then you go on, moreover, uncertainty about the strength of demand the risks of terrorism and war and so on have caused businesses to be cautious.

Mr. ANDERSON. Right.

Senator STABENOW. Could you speak to that? Because I think that is very important as we debate how we stimulate the economic, how we do things in a way that will strengthen and hit the right points. It seems to me you are saying very clearly that demand and bringing down that excess capacity is important in terms of stimulating the economy.

Mr. ANDERSON. Well, you have hit on the highlights of what our major concern here is, and particularly your reference to the uncertainties aspect. We feel that much of the lack of demand, both on consumers and on the part of businesses, and much of the low level of capacity is very, very much related to the uncertainties involved. Again, it is not just the business uncertainties. We highlight those. We talk about those. The world gets smaller every day. We have much more competition with people outside the country here, the foreigners. It is the geopolitical.

The resolution of that kind of geopolitical we feel is perhaps much more important, and perhaps much important than we can give credit for here, because it is so difficult for economists or forecasters or businessmen to really tie those larger issues together with the impact that it has on consumer confidence, business confidence.

Now, after having said that, are we in the conditions for a jump-start, if you will? Are we in the conditions for stimulus? Yes. You mentioned history, and I do like history, not just military but also financial and economic. Our estimates, our success at doing stimulus proposals in the past has not been uniformly good. Frequently, we have get the timing exactly wrong. That is, by the time we take the actions to do particularly a fiscal policy impact on jump-starting the economy, the economy will have changed in and of itself. Monetary policy is perhaps another thing. Monetary policy generally can be done much quicker than fiscal policy.

So my comment to you is that I agree, we are in the conditions now—and it certainly has been discussed actively by not only the political environment but by the economic environment—that we might be ripe for, could be very ripe for a jump-start stimulus. Timing is paramount, though.

Senator STABENOW. I agree. You are saying exactly what many of us have said in terms of having whatever happens happen immediately. From what you are saying, this needs to be focused on consumer confidence and demand and all of those efforts that are different than some, certainly than what we have heard in terms of many of the tax proposals that are more long term as opposed to immediate and focusing on demand.

I would just say, in conclusion, one other comment. I found it interesting and very important to note for the record that when we look at the next 10 years and the focus on whether we will be in surplus and when, it is important to note that of the $1.3 trillion that is projected in a cumulative surplus over the next 10 years, as you indicate, the last 3 years are almost entirely responsible for that total and that that accounts for 93 percent of the 10-year sum.

That is because you assume that at the end of 10 years the tax cuts are not extend. Isn't that correct?

Mr. ANDERSON. That is correct.

Senator STABENOW. So that we only have surplus, 93 percent of what you are projecting occurs only if those tax cuts are not extended. If they are extended, do you have numbers at this point as to what we are talking about in terms of debt?

Mr. ANDERSON. I have them. I don't know exactly—I was asked before, and I will provide them for the record. The surpluses do not evaporate, but they remain very small. So basically, just as the numbers we have for the initial years would indicate, if we were to get rid of the—if we were to retain the tax cuts, we would have surpluses of very small levels, not only nominal amounts but as a percent of GDP, from basically the next 2 or 3 years throughout the 10-year period.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Stabenow, thank you very much.

Next we call upon Senator Ensign.

Senator ENSIGN. Thank you, Mr. Chairman.

I want to go back to a line of questioning regarding the 10-year numbers. Tax cuts wipe out the surplus, or at least greatly decrease it. Second, you don't project any increases in discretionary above inflation because you are not allowed to. Is that correct?

Mr. ANDERSON. Correct.

Senator ENSIGN. If you project those out, what happens to the surplus?

Mr. ANDERSON. It is gone.

Senator ENSIGN. OK. I just wanted to make sure. I don't want to get partisan about this, but we have heard a lot about the tax cuts. Last week we had on the floor of the House the omnibus bill. There were $500 billion in new spending increases voted on in that bill—$500 billion over the 10-year period of time.

Senator CONRAD. Would the Senator yield?

Senator ENSIGN. In just a second. The President's proposal on tax cuts is about $670 billion over 10 years. I haven't seen too much economic modeling that state that the spending increases are going to actually grow the economy, where tax cuts—that is the whole point. The purpose for tax cuts is a supply side effect. During the 1980's, we saw a tripling of the debt.

Three factors. One, we had going into the 1980's—tremendously high interest rates. Second, we had a dramatic decrease in the size of the Defense Department that had to be rebuilt. Third, the tax cuts actually increased revenues to the Government. We outpaced those increases in revenues to the Government by spending, both mandatory and discretionary spending. Is that correct?

Mr. ANDERSON. We believe at CBO, consistent with most other economists, that there is a dynamic or supply side effect to tax cuts, although I want to be very careful, it depends upon the tax cut.

Senator ENSIGN. The kind of tax cut.

Mr. ANDERSON. Absolutely.

Senator ENSIGN. I totally agree with that.

Mr. ANDERSON. How permanent in nature, and there are very different kinds. In addition, we believe that the effect is very much influenced about how the tax cut is financed. In fact, we are seeing that today. Where we have a tax cut that goes through 2010 and then, if you will, expires. Well, the economic impact of a tax cut that goes out for 6 or 7 years and then goes away is much, much, different, I think, than an economic impact of one that goes out permanently and is also financed by spending cuts.

Senator ENSIGN. I think it is fine to look out 10 years, but at the same time, we are so off on 1- and 2-year numbers, I have little faith in 10-year numbers. I think we should have fiscal discipline. I don't want to add to the voices that say there is not a problem with running deficit, as long as you keep the deficit at a certain percentage of the GDP. I believe that we should look to not only balancing the budget but also paying down the debt. I am a strong believer in that. Lastly, I also believe that certain types of tax cuts can stimulate the economy. The one thing I have learned in Washington, D.C., is we don't cut spending. There just is not a lot of appetite here to cut spending. I am one of the few that actually will vote to cut spending, and the best we can hope to accomplish is to slow the rate of growth of government spending down. We continue to increase and increase and increase spending up here. I would like to see the rate of growth slow down and have some tax cuts. That seems to me the only way that you are going to take care of the deficit. I believe a combination of slowing down spending with the right kind of tax cuts is the only way for us to get to where we all want to be, and that is where we are not leaving our children and our grandchildren, with a country that is debt-laden.

I apologize to Senator Conrad, I took so long to yield.

Senator CONRAD. No, I appreciate it very much, Senator.

The Senator mentioned that we voted on $500 billion of spending increases.

Senator ENSIGN. Correct.

Senator CONRAD. I would just say to the Senator, that is just not correct. We voted on $27.7 billion of spending increases. Those were 1-year appropriations—1-year appropriations. The only way you get to $500 billion is you accumulate it over 10 years. There is no requirement—there is no requirement that you have additional expenditures for follow-on years.

Senator ENSIGN. We have all seen up here, when we do 1-year expenditures they get added into the baseline. We don't just do 1-year expenditures on education or on anything else, and then the next year cut it back. We never do that. It gets added into the baseline. That is why that $500 billion number, I believe, is real. Senator Stabenow said let's look at the past. I haven't been around this place for too long, but it doesn't take long to realize that things don't get taken away.

I think back to Ronald Reagan's famous statement, the best way to eternal life is to become a Federal agency or a Federal expenditure. It never goes away.

I think that we should be consistent. Let's look for the right kind of tax cuts to stimulate the economy and have some restraint on Federal spending and that is how we will get out of these deficits.

I thank the Chairman for the time.

Chairman NICKLES. I thank the Senator.

Senator Allard.

Senator ALLARD. Mr. Chairman, thank you. I just want to go into the debt limit just briefly here, if I may. Right now, when we talk about our debt limit, we are talking about the total debt. We are not talking about the public debt. That is correct?

Mr. ANDERSON. Correct.

Senator ALLARD. Just share with us some of the—maybe historically why it is that when we set the debt limit—this is actually money going outside the Government for money to be put in. There is an obligation out there. Why is it that we don't use the public debt as the limit as opposed to the total debt?

Mr. ANDERSON. I am not exactly aware of exactly why the decision was made many years ago to use what we call in the budgeting community the gross debt, that is, the debt not only that goes outside the Government, the debt to the public, but also that portion of securities that are given to Government agencies, such as those that operate trust funds. So I am not sure exactly of the limit, but the irony of that is that if one looks at the two changes that we have had, the last two changes we have had in the debt limit, the one from 1997 to just recently, the changes in that were almost exclusively—I believe exclusively because of an increase in the amount of debt for inside the Government. Over that period of time, we have actually reduced the debt that went to the public, the outside.

Senator ALLARD. You know, the only thing I could think of is that perhaps maybe they were just looking at the obligations on the general fund, in which case these trust funds—like Social Security is a future obligation on the general fund if we are going to honor those notes which automatically go out on Social Security, for example, or any of the other funds. I think that is an automatic obligation on the general fund.

Mr. ANDERSON. It may well have been. There have been proposals recently also to decrease the amounts of moneys coming into trust funds and make up for those losses by transfers from the general fund. Well, that——

Senator ALLARD. That is a future obligation, exactly.

Mr. ANDERSON. Yes, that would have debt limit concerns then under the current definition that we have. It is an odd and confusing thing to explain to the public.

Senator ALLARD. Now, we just raised the debt limit last year, the first part of last year, I think, didn't we? We are at $6.4 trillion.

Mr. ANDERSON. Yes.

Senator ALLARD. The Administration at the end of this last year—or somebody in the Administration has suggested that maybe we need to raise that a trillion or so. Can you share with us some of the thoughts—or has the Administration shared some of the thoughts of why they think that might be necessary?

Mr. ANDERSON. I believe just before Christmas the Treasury Department came to the Congress and said that they needed an increase—I don't recall the exact amount—of the debt limit and that they would need it by about a month from now. The cash-flows of Treasury are such that April, as you might imagine, is our big cash intake month. Because so many people resolve—both individuals and corporations, but particular individuals resolve their tax liabilities about the middle of April, because of that, Treasury does need or run short of income in February and March, and I believe what Treasury said, that under current projections—and we looked at them carefully and we believe that we are consistent with them—they are going to bump up against the current debt limit of $6.4 trillion sometime around a month from now, that is, at the end of February.

Senator ALLARD. At the end of February. I mean, if we would deal with the debt limit in this particular piece of legislation, our resolution, I guess we wouldn't. We need—that is a statutory change, isn't it?

Mr. ANDERSON. I believe so, yes.

Senator ALLARD. This is a resolution. So we will have to probably deal in the Congress, if we are going to raise that debt limit, we are going to have to deal with that within—before this resolution actually gets even reported out of the Senate.

Mr. ANDERSON. I believe so, yes.

Senator ALLARD. OK.

Mr. ANDERSON. Again, Senator, though just as we talked about from 1997 to 2002, a good portion of that is the increase in debt to trust funds.

Senator ALLARD. Yes. Now, there is also—I mean, our budget has been pretty impacted by the cost of the war. We have had an impact there. I think there has been a cost to the war there. How have you figured in—and I am sorry I missed your presentation. I had another committee meeting. Did you talk anything about the future potential costs of this war? We could be right in the middle of this resolution, and we could potentially—I am not saying we are going to be, but potentially be at war with Iraq. We are amassing our troops on the borders now, and so there is some extra cost there. Have you given that any thought?

Mr. ANDERSON. We have given it a lot of thought, and I did talk about it a bit, but it is easy to summarize.

First of all, in our baseline projections where we do not make, explicitly do not make forecasts of congressional action, we do not have any forecast of what additional appropriations the Congress may provide to the Department of Defense for conducting the war.

Second of all, the major impact of the war could be its impact on the economy. By its impact on the economy, I mean not just oil but in a much broader sense, particularly on consumer and business confidence.

We at the Congressional Budget Office try to take into account what the private sector forecasters of the economy do. We have an extensive panel of economic advisors that meets twice a year. We regularly communicate with them, and we do an awful lot with what is known as the blue chip, taking a look at the consensus and various different estimates there. We are not sure exactly what they have done with an expectation of the war or not. Our estimates are such that we feel that these larger geopolitical risks are not really something one can estimate on the economy.

So our economic projections and the baseline that we presented here this morning is basically not taking into account what war might do to the economy. It could be positive. A quick resolution of the war could take away a lot of the uncertainty and could get—just to pick oil, for example, lower the price of oil considerably. There are many, many other scenarios that go well into the opposite direction and would cost not only the Federal budget but also the economy billions and billions of dollars.

Senator ALLARD. I am going to change completely away now from that and go into the tax cut area. When we put in place the temporary tax cuts a year and a half ago, the Congress here, I noted in an editorial by the Washington Post—and they have never been any friend particularly of those of us who want to cut taxes, but they had to admit in one of their editorials, very short in that editorial, that the temporary tax cuts that were put in place a year and a half ago that extended out only over 10 years actually did help buoy up the economy.

Do you have any evidence to indicate from what you have put in that those tax cuts did actually help buoy up the economy so that it kept us out of going any further than what we have gone if they hadn't been in place?

Mr. ANDERSON. We have looked at the impact of the tax cuts, temporary, yes, but temporary through 2010, and also the increased spending. I have been in budgeting for many years and looked at many different efforts to provide a jump-start or a stimulus. As you may have heard me say just a few moments ago, I think one of the problems of using fiscal policy in that sense is getting the timing right. There have been so many times in the past when, because of the delays of passing the legislation and then actually implementing the various different types of tax or spending for stimulus purposes, that frequently we have missed the timing; that is, we provided the stimulus tax cuts or spending at the wrong time after the economy has picked up.

Last year, I think we hit it right. We may have been lucky. I am not sure it was the immense wisdom of those of us here in Washington. Nevertheless, from an economic perspective, I think we hit it right. By that I think we mitigated the depth of the downturn by the combination of the fiscal policies that we made.

Senator ALLARD. So your bottom line is that we did help buoy up the economy from your point of view.

Mr. ANDERSON. Yes, we did. We have some estimates of exactly how much that was. I will be happy to provide them for you for the record.

Senator ALLARD. I would appreciate that if you would provide it.

Mr. ANDERSON. Certainly.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman NICKLES. Senator Allard, thank you very much.

We are delighted to also have Senator Sessions join us, a new member of the Committee. Welcome, Senator Sessions.

Senator SESSIONS. Thank you. I won't—I had an important Judiciary Committee meeting. I just had to be there, and I am sorry I couldn't be here earlier.

After the last Gulf War, the price of oil did plummet significantly, didn't it?

Mr. ANDERSON. It really did, yes.

Senator SESSIONS. Was that a factor in the general economic growth that we sustained after the Gulf War?

Mr. ANDERSON. I think it was definitely a factor, and not just the price but also certainty, as we have been talking about here, the levels of uncertainty on the economy were diminished after the last war. We hope they will be diminished shortly here, too.

Senator SESSIONS. Well, I know that a lot of people are nervous about the economy and they would like to see it bounce back. There are things that indicate that it is healthy enough that the market should reflect that, and it hasn't shown that. I suspect some of it is nervousness over the war, and the sooner we can get that over, I think we can have every prospect—and I am glad you agree—that some stability in the region, we could show a reduction in oil prices, which could be key to long-term growth. Certainly that can be our hope.

That is all I have, Mr. Chairman.

Chairman NICKLES. Senator Sessions, thank you very much.

I would make just a couple quick comments. I was kind of fumbling around for the record. Its total amount of money that we pay for Social Security and Medicare approximately equal to the total taxes that we receive in Social Security and Medicare?

Mr. ANDERSON. The total amount of money we pay for Social Security and Medicare now is less than the amount of taxes that we pay because of the general fund transfers that we make, particularly to Medicare Part B.

Chairman NICKLES. OK. That wasn't my question.

Mr. ANDERSON. I am sorry.

Chairman NICKLES. My question was: Is total amount of money that we pay in Social Security and Medicare equal to the total taxes we take in Social Security and Medicare? I know there is presently some general revenue fund that supplements Part B, but I think if you take that out, they are roughly equivalent, I think the income and the outlays are roughly equivalent, and I want you to substantiate that or correct me if I am wrong.

Mr. ANDERSON. I believe that it is largely true. That is right. Yes, it is.

Chairman NICKLES. There are a lot of misconceptions about trust funds, period.

Mr. ANDERSON. Yes, there is.

Chairman NICKLES. A lot of misconceptions that maybe at some point we need to try to figure out or better explain. I believe the total payroll taxes, the 15.3 percent, which includes Social Security and Medicare, the total money that is received on payroll taxes for those two accounts are roughly equivalent to the outlays that we make every year on those two programs.

Now, granted, Medicare has—we say we supplement—we transfer general revenue funds and so on, but, anyway, revenues, I believe, and outlays are roughly equivalent for those two programs.

Mr. ANDERSON. I believe you are correct.

Chairman NICKLES. You could correct me if I am wrong, or you could give me something for the record if that is incorrect. I think Senator Conrad and I are both concerned about long-term viability of both programs. We will have hearings that will deal with those at a later point. I am planning on having a Medicare hearing and we may do a Social Security hearing as well. I am really concerned.

Those are two programs that have a lot of attention and I think some confusion on trust funds that I wrestle with.

One other question is in regards to what Senator Allard was talking about on debt limit. The publicly held debt is what, $3.7 trillion?

Mr. ANDERSON. 3.2 or 3.3 trillion? I should have that on my fingertips.

Chairman NICKLES. $3.5 trillion at the end of 2002.

Mr. ANDERSON. Right.

Chairman NICKLES. Does it really make sense or is it necessary—I know you mentioned that you thought we would be up against the statutory debt limit by the end of next month or close to that time.

Mr. ANDERSON. Right. That is correct.

Chairman NICKLES. The statutory debt limit also includes debt owed the trust funds or debt owed the Government; is that correct?

Mr. ANDERSON. That is correct.

Chairman NICKLES. We are not going to be bouncing checks on those. Those are basically governmental entries. Does it make sense to have the debt limit exceed what is in excess of the publicly held debt?

Mr. ANDERSON. First of all, I think it is very, very confusing for the public, that is, to try to talk about a debt limit that has a limit on debt that the public doesn't actually incur, the intergovernmental transfers.

What the purpose was when it was originally instituted many decades ago, I don't know. I am just not aware of that. I do not find it from a budgetary perspective particularly helpful to have the liabilities of intergovernmental accounts reflected as part of the debt limit.

Chairman NICKLES. I appreciate that. I may even do a hearing one of these days, Senator Conrad, on some of the trust funds and misconceptions and so on.

Let me ask you one addition question. If we did make the President's tax cut that passed in 2001 permanent, would we continue under your projections under the baseline to have surpluses for all those years?

Mr. ANDERSON. Yes. Deficits would decline, as we indicated, in the near term, get to surpluses, small surpluses, and then remain there through 2013.

Chairman NICKLES. I appreciate that. I look forward to working with you.

Mr. Anderson, I have several questions that I think I will submit to you for the record and would appreciate your response to those as well.

Chairman NICKLES. Senator Conrad, do you have any final comments?

Senator CONRAD. I do. Thank you, Mr. Chairman.

On the last point that was made, I think we have to be very careful about the message we send the American public about surpluses. There are no surpluses here anywhere, anywhere in sight, under any scenario. Your baseline doesn't include, does it, any provision for making the tax cuts permanent?

Mr. ANDERSON. It does not.

Senator CONRAD. There is no provision in your baseline for the President's growth package and the revenue loss from that, is there?

Mr. ANDERSON. That is correct, no provision.

Senator CONRAD. There is no provision in your baseline for the President's proposal on reforming Medicare or providing a prescription drug benefit.

Mr. ANDERSON. That is correct.

Senator CONRAD. There is no provision in your baseline for growth in spending for homeland security above inflation.

Mr. ANDERSON. Correct.

Senator CONRAD. There is no provision in the baseline for potential costs of the war.

Mr. ANDERSON. Correct.

Senator CONRAD. You have indicated potential costs of the war, if there were a 5-year occupation, relatively short conflict, I think those estimates were in the hundreds of billions of dollars, were they not?

Mr. ANDERSON. I believe for a 5-year occupation that would get up into that level.

Senator CONRAD. The other thing that is important to understand is in the baseline, you are jackpotting, you are including Social Security Trust Fund surpluses over the next decade; is that not correct?

Mr. ANDERSON. I presented them on a unified basis.

Senator CONRAD. Unified basis.

Mr. ANDERSON. Right.

Senator CONRAD. Which means all the funds are jackpotted, which means there is no special treatment for Social Security surpluses or for other trust funds. They are really not treated as trust funds. All the money is jackpotted.

The problem with that is, I believe, that it misleads the American people as to our true financial condition. No company in America could jackpot its retirement funds or its health care funds for employees and pay operating expenses out of that, could they? Could any company do that?

Mr. ANDERSON. We certainly have a different way of treating our trust funds than anybody else, and I think I agree with what you are saying with respect to the confusion that it causes the American public. Even the mere phrase "trust fund" we treat differently than what you or I or the American public or businesses treat as trust fund.

Senator CONRAD. You know, the thing that has always struck me, I came from a financial background to the Congress, and I started out in this committee way at the end of the table there. I will never forget when I had my first briefing on how the Federal Government does its accounting. To me, it is totally misleading. I had a long talk with Chairman Greenspan about this 2 weeks ago, and I personally believe we ought to go to an accrual system, because that would demonstrate to people there are no surpluses here, under any scenario, under any presentation. Even if you leave out the President's proposals for additional spending and additional tax cuts, all that aside, there are no surpluses. Because in an accrual system, what would show is that we have these incredible liabilities that are hanging over us, for Social Security, for Medicare.

The reason they don't appear on the balance sheets of the Federal Government is because the notion is Congress could change those programs on 30 days' notice. That is the reason we don't show them as contingent liabilities. Does anybody believe these are not truly liabilities? I don't think there is a member around this dais that wouldn't say those are real liabilities.

Chairman NICKLES. Just to echo some of the things Senator Conrad is saying, I am happy to get into some of our unfunded liabilities that we are looking at in some of our programs—Social Security, Medicare. Both—well, Medicare certainly, and Social Security for the most part, a PAYGO system. It is so far from being a funded system. I think the unfunded vested liability in Social Security is more like $10 or $11 trillion. So one could put that figure down if you want to say actual debt, you could add that. It is a liability. We basically agreed to pay for it on a PAYGO basis, right or wrong. Some people would like to change the system, and I think maybe with some merit, to provide for a vested capitalized system, but that would take some transition and some political cooperation to make that happen.

Senator CONRAD. I go back to any private company, there is no company in America today that could take the retirement funds of its employees, the health care funds of its employees, and use them to pay operating expenses. If they did that, they would be on their way to a Federal facility, but it wouldn't be the Congress of the United States.,

Chairman NICKLES. They would also be on their way to a Federal facility if they used PAYGO. Every company in America has actuarial standards that they must meet that the Federal Government does not.

Senator CONRAD. Absolutely. This may be an area where the Chairman and I are on the same page. I think we would do the country a tremendous service if we would have hearings that would focus on these unfunded liabilities and where we are headed, the demographic time bomb we face, and what the implications are for future policy. Perhaps that will be another day.

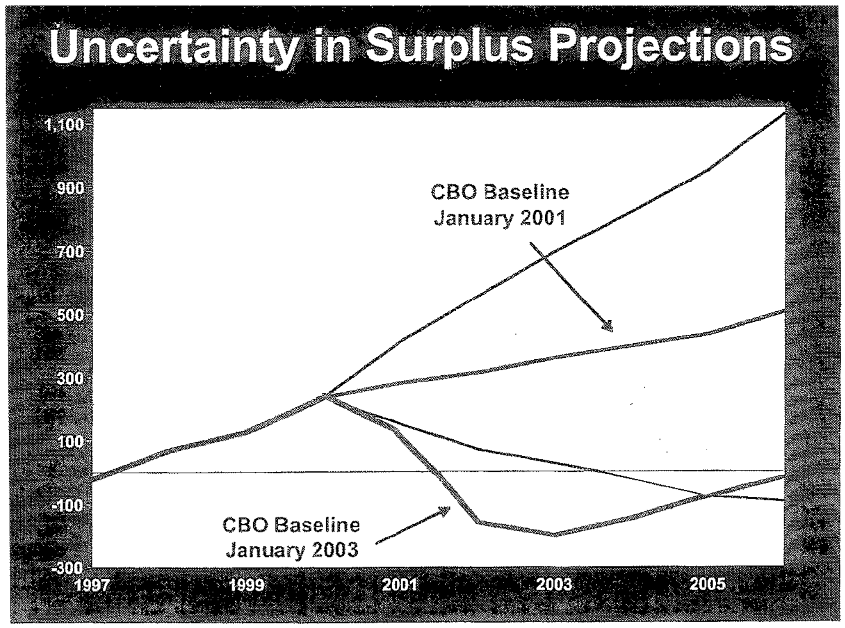
Chairman NICKLES. I look forward to working with you.

Mr. Anderson, thank you very much.

Chairman NICKLES. For the members of our committee, our next hearing will be on Tuesday. We will have Mr. Glenn Hubbard, who is the President's Council on Economic Advisers, present to us at 2:30 on Tuesday.

The committee is adjourned.

[Whereupon, at 11:48 a.m., the committee was adjourned.]


Uncertainty in Surplus Projections
1,100
900
700
500
300
100
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-300
CBO Baseline
January 2001
CBO Baseline
January 2003
1997
1999
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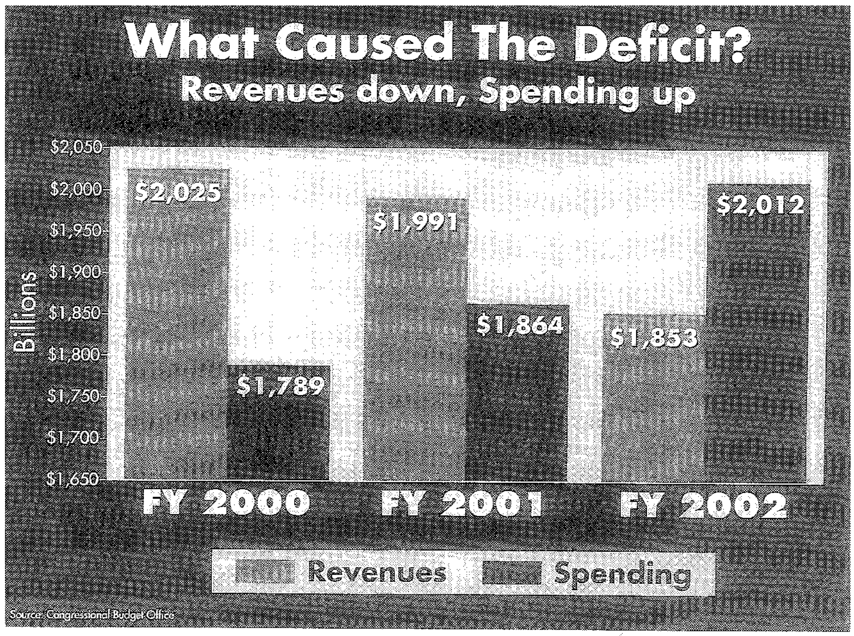
What Caused The Deficit?
Revenues down, Spending up
Billions
$2,050
$2,000
$1,950
$1,900
$1,850
$1,800
$1,750
$1,700
$1,650
$2,025
$1,789
$1,991
$1,864
$1,853
$2,012
FY 2000
FY 2001
FY 2002
Revenues
Spending
Source: Congressional Budget Office

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Dan L. Crippen, Director

September 30, 2002

Honorable Kent Conrad
Chairman
Committee on the Budget
United States Senate
Washington, DC 20510

Honorable John M. Spratt, Jr.
Ranking Member
Committee on the Budget
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman and Dear Congressman:

In response to your request of September 20, 2002, the Congressional Budget Office (CBO) has estimated the cost of activities related to possible military operations in Iraq. Estimates of the total cost of a military conflict with Iraq and such a conflict's aftermath are highly uncertain. They depend on many factors that are unknown at this time, including the size of the actual force that is deployed, the strategy to be used, the duration of the conflict, the number of casualties, the equipment lost, and the need for reconstruction of Iraq's infrastructure.

Of the many options being discussed for force structures, CBO examined two representative examples that vary in their emphasis on ground or air forces. Under the assumptions of those examples, CBO estimated that the incremental costs of deploying a force to the Persian Gulf (the costs that would be incurred above those budgeted for routine operations) would be between $9 billion and $13 billion. Prosecuting a war would cost between $6 billion and $9 billion a month—although CBO cannot estimate how long such a war is likely to last. After hostilities end, the costs to return U.S. forces to their home bases would range between $5 billion and $7 billion. Further, the incremental cost of an occupation following combat operations could vary from about $1 billion to $4 billion a month.

The attachment to this letter describes the basis for CBO's estimates, which were prepared by Matthew Schmit and David Newman of CBO's Budget Analysis Division; and by Greg Kiley, Paul Rehmus, and Adam Talaber of CBO's National Security Division. If you wish further details, we would be pleased to provide them. CBO's staff contacts are Jo Ann Vines (226-2840) and J. Michael Gilmore (226-2900).

Sincerely,

Dan L. Crippen
Director

Attachment

Honorable Kent Conrad
Honorable John M. Spratt, Jr.
Page Two

cc: Honorable Pete V. Domenici
Ranking Member

Honorable Carl Levin
Chairman
Committee on Armed Services

Honorable John W. Warner
Ranking Member

Honorable Robert C. Byrd
Chairman
Committee on Appropriations

Honorable Ted Stevens
Ranking Member

Honorable Jim Nussle
Chairman

Honorable Bob Stump
Chairman
Committee on Armed Services

Honorable Ike Skelton
Ranking Member

Honorable C.W. Bill Young
Chairman
Committee on Appropriations

Honorable David R. Obey
Ranking Member

Estimated Costs
of a
Potential Conflict with Iraq

Congressional Budget Office

September 2002

Summary and Introduction

Estimates of the total cost of a military conflict with Iraq and the conflict's aftermath are highly uncertain and depend on many unknown factors including the actual force size deployed, the duration of the conflict, the strategy employed, the number of casualties, the equipment lost, and the need for reconstruction of Iraq's infrastructure. Of the many force-level options being discussed, CBO examined two representative examples. Both alternatives are based to some extent on the forces that the Department of Defense (DoD) had previously indicated it would require for a major theater war. Using those forces, CBO employed various methods to develop its estimates. As appropriate, it used cost data from prior and current military operations—most notably, the operations in the Balkans, Afghanistan, and Desert Shield/Desert Storm. In addition, CBO estimated costs using categories similar to those in DoD's annual reports on the Overseas Contingency Operations Transfer Fund—personnel and personnel support, operations support, and transportation.

Under the assumptions incorporated in its examples, CBO estimates that the incremental costs of deploying a force to the Persian Gulf would be between $9 billion and $13 billion. (See the explanation below of "incremental costs.") Prosecuting a war would cost between $6 billion and $9 billion a month—although how long such a war may last cannot be estimated. After hostilities end, the costs to return U.S. forces to their home bases would range between $5 billion and $7 billion, CBO estimates. Further, the incremental cost of an occupation following combat operations would vary from about $1 billion to $4 billion a month. The estimates of monthly costs incorporate no assumptions about the duration of the conflict or the occupation. And CBO has no basis for estimating any costs for reconstruction or for foreign aid that the United States might choose to extend after a conflict ends.

The first of CBO's examples emphasizes ground forces. Called the Heavy Ground option in this report, it includes about five U.S. Army divisions and five U.S. Air Force tactical fighter wings. The second option relies more on air power. Termed the Heavy Air option, it comprises two and one-third U.S. Army divisions and 10 U.S. Air Force tactical fighter wings. (Details of the options are displayed in Tables 1 and 2.) CBO estimates that the cost of deploying the Heavy Ground force to the Persian Gulf would be about $13 billion; after that, the incremental cost of prosecuting a war in Iraq would reach just over $9 billion during the first month of combat and subsequently fall to about $8 billion a month (see Table 3). Similarly, the cost of deploying the Heavy Air force to the Persian Gulf would be $9 billion, and the incremental cost of prosecuting a war would reach $8 billion during the first month of combat and then fall to $6 billion a month (see Table 4). Eventually, forces deployed to the conflict from other locations would return to their home stations. CBO estimates that the costs to redeploy those forces would be approximately $7 billion for the Heavy Ground force and $5 billion for the Heavy Air force.

CBO's estimates represent the incremental costs that DoD could incur above the budgeted cost of routine operations. As a result, the estimate excludes items such as the basic pay of active-duty military personnel but includes the monthly pay for reservists recalled to full-time duty. Similarly, the estimates reflect only the costs of aircraft flying hours and ship steaming days above those normally provided in DoD's regular appropriations. CBO has no basis for estimating the number of casualties from the conflict or for analyzing the effects of Iraq's possible use of weapons of mass destruction; thus, the estimates in this report exclude those considerations. Neither is there a basis for estimating the costs associated with activities conducted under the National Foreign Intelligence Program because the details of its activities are highly classified.

CBO's Assumptions About Forces

As the basis for its estimates, CBO assumed that forces would be significantly smaller than those DoD has previously proposed for fighting a major theater war (MTW). In DoD's plans, an MTW force included about five active Army divisions, 10 Air Force tactical fighter wings, five to six Navy aircraft carriers with associated support ships, and one to two Marine Corps expeditionary forces (MEFs).[1] In its estimate, CBO examined one option that emphasizes ground forces—Heavy Ground—and another that relies more on air forces—Heavy Air (see Tables 1 and 2); both of those options are subsets of the MTW force, and both are significantly smaller than the forces used to fight the Desert Storm campaign.

The Heavy Ground Option. In estimating costs for this option, CBO assumed the use of five Army divisions, but limited tactical air forces to half of those planned for an MTW, or about five wings, on the assumption that the bases available to U.S. and allied air forces might be limited or that extensive use of precision munitions might make the use of a smaller number of aircraft feasible. CBO also assumed that this force would include one MEF. In total, CBO estimates, the U.S. force would include about 370,000 military personnel deploying to the Persian Gulf region (270,000 active-duty service members and 100,000 reserves). About another 70,000 reserves would be required to fill stateside and other positions left vacant by deploying active-duty troops. The U.S. force would also comprise up to 1,500 aircraft, 800 attack and transport helicopters, 800 tanks, and 60 battle force ships.

Which allied forces might participate in a conflict with Iraq is uncertain; only the British have thus far indicated their intention to contribute troops. Thus, CBO assumed that two-thirds of a British heavy armored division and two-thirds of a British air wing would

1. A Marine expeditionary force consists of one Marine division and one Marine air wing.

be part of the Heavy Ground force, as well as a British naval contingent of 21 ships, as in Desert Storm. CBO's estimates of the costs incorporate the assumption that the United States will provide limited logistical support to those forces similar to the support it provided during Desert Storm.

The Heavy Air Option. In its estimates of an option emphasizing air forces, CBO limited U.S. Army forces to two and one-third divisions and increased the number of tactical air wings to 10. That force structure assumes an increased reliance on air power to compensate for the smaller ground force. For this option, CBO assumed the use of about one-third of a MEF. In total, CBO estimates, the U.S. force would include about 250,000 military personnel deploying to the Persian Gulf region (200,000 active-duty service members and 50,000 reserves). Another 55,000 reserves would be required to fill stateside and other positions left vacant by deploying active-duty troops. The Heavy Air force would also comprise up to 2,500 aircraft, 500 attack and transport helicopters, 300 tanks, and 60 battle force ships.

CBO assumed that one-third of a British heavy armored division and one British air wing would be part of the Heavy Air force, as would the same British naval contingent of 21 ships assumed for the Heavy Ground estimate. Again, the United States would provide limited logistical support to those forces similar to the support provided during Desert Storm.

Incremental Costs for Deploying and Operating Forces

Detailed below are CBO's estimates of the incremental costs for operations by the two representative force structures during both the potential conflict in Iraq and its aftermath.

The Heavy Ground Option. CBO estimates that building up and deploying a U.S. force composed of approximately five Army divisions, approximately five Air Force wings, five Navy aircraft carriers with associated escort and support ships, and one Marine Corps expeditionary force would cost almost $13 billion over a three-month deployment phase. For that phase, costs for operations support constitute 43 percent of the estimate, or over $5 billion (see Table 3). Operations support includes the costs associated with operating and maintaining all air, land, and sea forces assembled in the region before the conflict commences; the costs associated with the incremental increase in flying hours and steaming days, such as the costs for increased fuel consumption and repair parts; the costs of equipping and maintaining ground troops and purchasing equipment; and the costs associated with command, control, communications, and intelligence.

Costs for personnel and personnel support during the deployment phase constitute another 34 percent of the estimate's total, or $4 billion; they include the costs for reserve personnel called to active duty as well as special payments, such as hazardous-duty pay, for both reserve and active-duty personnel. Costs for transporting troops and equipment into the theater would be $3 billion, or 22 percent of the estimate, and are based on tonnage levels and costs for Desert Shield and Desert Storm, and DoD's planning factors for supplies associated with each deployed soldier. In addition, they take into account the personnel, equipment, and supplies already in and around the Persian Gulf.

CBO estimates that once combat begins, the costs for prosecuting the war, including the cost to replace expended munitions and damaged or destroyed equipment, would total $9 billion over the first month of combat. The costs associated with replacing expended munitions account for 41 percent of that estimate. The cost of operations support (less the cost of expended munitions) accounts for 36 percent; personnel, personnel support, and transportation costs account for another 23 percent. CBO assumes that in the first month of the conflict, 50 percent of the targets assigned to aircraft would be attacked with precision-guided munitions, such as the Joint Direct Attack Munition (JDAM). CBO assumes that in the second and subsequent months of combat, 10 percent of the targets would be attacked using precision munitions. The war's monthly cost would in turn decline by almost 20 percent, to $8 billion a month.

At the end of hostilities, the cost to return the Heavy Ground force units to their home bases would be about $7 billion, CBO estimates. That figure includes the cost of returning about 25 percent of the total tonnage of equipment and supplies shipped to the region (after accounting for the fuel and ammunition consumed during the conflict) and all of the personnel initially sent to the area. On the basis of DoD's experience in Desert Storm, CBO assumed that the redeployment phase would last about three months. The costs for personnel and personnel support and for operations support for that period are estimated at $4 billion and $2 billion, respectively.

The Heavy Air Option. CBO estimates that building up and deploying a U.S. force composed of two and one-third Army divisions, 10 Air Force tactical air wings, five Navy aircraft carriers with associated support ships, and about one-third of a Marine expeditionary force would cost $9 billion. For the deployment phase, costs for operations support constitute 48 percent of that estimate, or $4 billion (see Table 4). Personnel and personnel support costs account for another $3 billion (31 percent), and transportation costs account for the remaining $2 billion (21 percent).

CBO estimates that once combat begins the costs for prosecuting the war, including the cost to replace expended munitions and damaged or destroyed equipment, would total about $8 billion over the first month of combat. The costs associated with replacing expended munitions represent 45 percent of that estimate. The cost of operations support (less the cost of expended munitions) accounts for 36 percent; personnel, personnel support, and transportation costs account for another 19 percent. CBO again assumed that 50 percent of the targets assigned to aircraft in the early phase of combat would be attacked with precision munitions. In the second and subsequent months, CBO assumed, 10 percent of the targets would be attacked using precision munitions, and the war's monthly cost would decline by about 20 percent, to $6 billion a month.

At the end of hostilities, the costs to redeploy the Heavy Air force would total about $5 billion. Included in that estimate are the costs for returning about 25 percent of the total tonnage of equipment and supplies shipped to the region (after accounting for the fuel and ammunition consumed) and all of the personnel initially sent to the area. As it did for the Heavy Ground option, CBO assumed that the redeployment phase would last about three months. The costs for personnel and personnel support and for operations support for that period are estimated at $3 billion and $1 billion, respectively.

Occupation. The costs associated with an occupation force for Iraq remain highly uncertain, varying from about $1 billion to $4 billion a month, depending on the assumptions used about force size and operations. Some military experts suggest that a force of up to 75,000 peacekeepers might be needed; another plan discussed by the U.S. Central Command calls for up to 200,000 troops. For its estimate, CBO used an average cost for a U.S. Army peacekeeper consistent with experiences in Bosnia and Kosovo, and assumed that U.S. force levels would range between 75,000 and 200,000 troops. It also assumed that replacement occupation personnel and equipment would be periodically rotated to the theater in a manner similar to that used in recent peacekeeping activities. However, current Army forces would be unable to support those rotations for a prolonged 200,000-person occupation.

Costs for an occupation could be significantly higher if that operation included the construction of bases, bridges, and roads. On the other hand, if the United States limited its role to providing logistical support to another country's peacekeeping forces, costs for an occupation could be significantly lower.

Uncertainties and Unknowns

Estimates of the total cost of a military conflict with Iraq and such a conflict's aftermath are highly uncertain. For example, many other force structures—both smaller and larger than the two examples CBO used in its estimates—could be fielded. A plausible, larger U.S. force might be composed of the ground forces assumed in the Heavy Ground option and the air forces assumed in the Heavy Air option. Such an alternative force would approach the strength of DoD's MTW force (discussed earlier), but would still be smaller than the force used for Desert Storm. The personnel associated with that larger force would number 470,000; its deployment and monthly operations costs would be greater than any of the costs displayed in Tables 3 and 4.

Whatever forces are used, unknown factors abound in considering how a conflict with Iraq would actually unfold. On the one hand, if the Iraqi leadership or selected elements of its military forces quickly capitulated, ground combat could be of short duration, as in Desert Storm. On the other hand, if the leadership and military chose to fight, Iraq's use of chemical or biological weapons (CBW) against regional military or transportation facilities could extend the war, as could the need to engage in protracted urban fighting. Given those uncertainties, CBO's estimates of the monthly costs of operations exclude expenditures for decontaminating areas or equipment affected by CBW attacks. CBO also has not attempted to estimate the number of potential casualties, including those that might result from the enemy's use of CBW or from protracted urban fighting.

A war could lead to substantial costs in later years that are not included in CBO's estimates, either because their magnitude could not be assessed even roughly or because they depend on highly uncertain decisions about future policy. The United States might leave troops or equipment in Iraq, which could require the construction of new military bases. Sustaining the occupation over time could require either increases in active-duty and reserve end strength or major changes in current policies on basing and deployment. The United States might provide Iraq with funds for humanitarian assistance and reconstruction. Aid could be provided in the future to allies and other friendly nations in the region, and levels of assistance could be substantial.

Some analysts have speculated that the proceeds from Iraqi oil sales could be used to offset the costs of reconstruction and occupation. However, Iraq is already a major exporter of oil and until recently has been producing at close to its peak sustainable production capacity of 2.8 million barrels a day (BPD).[2] Currently, about 80 percent of Iraq's oil production is being used to purchase imports under the United Nations Oil for Food Program or for domestic consumption. And, in the near term, Iraqi oil exports cannot be expanded without large-scale investment and development of infrastructure. Thus, the primary source of additional funds for reconstructing Iraq would be the proceeds from the legitimate sale of the approximately 400,000 BPD that are currently smuggled out of the country to pay for the importation of items that violate United Nations sanctions.[3] Assuming that a postconflict Iraq complied with all U.N. resolutions and removed the basis for the current economic sanctions, and assuming also that its oil production infrastructure was undamaged, Iraq could pay for reconstruction costs by using funds generated from that 400,000 BPD of oil and still have enough to pay for its country's current level of imports. At today's oil prices, production at that level would amount to approximately $3 billion a year.

2. According to data from the Department of Energy's Energy Information Administration and the Organization of Petroleum Exporting Countries (in its *Annual Statistical Bulletin,* Washington, D.C., 2000), Iraq produced an average of 2.8 million BPD in 2000 and 2.4 million BPD in 2001. Its peak surge capacity is about 3.1 million BPD.

3. Oil is smuggled through Syria (180,000 to 250,000 BPD); Jordan (75,000 to 110,000 BPD); Turkey (40,000 to 80,000 BPD); and other Persian Gulf states (30,000 to 40,000 BPD). See General Accounting Office, *Weapons of Mass Destruction: U.N. Confronts Significant Challenges in Implementing Sanctions against Iraq,* GAO-02-625 (Washington, D.C., May 2002).

TABLE 1. UNITED STATES FORCES USED IN DESERT STORM AND ASSUMED FOR CBO'S HEAVY GROUND AND HEAVY AIR OPTIONS

Major Force Element	Desert Storm	Heavy Ground	Heavy Air
Army Divisions[a]	7⅔	5⅓	2⅓
Marine Corps Divisions[a]	2⅔	1	⅓
Marine Air Wings	1	1	1
Navy Carrier Air Wings	6	5	5
Navy Carrier Battle Groups[b]	6	5	5
Navy Amphibious Ready Groups[b]	7[c]	1	1
Navy Surface Action Groups[b]	2	1	1
Air Force Fighter Wings[d]	9⅔	5⅓	10
Air Force Bombers	65	72	72

SOURCE: Congressional Budget Office.

a. Fractions of divisions represent additional brigade-sized elements (armored cavalry regiments or Marine expeditionary brigades) that would be deployed with combat divisions.

b. By the end of Desert Storm, more than 100 Navy battle force ships had participated in that conflict. For both the Heavy Ground and Heavy Air options, CBO estimates that the United States would deploy 60 Navy battle force ships.

c. During Desert Storm, Navy amphibious forces were not organized into amphibious readiness groups (ARGs). Thirty-one amphibious ships participated in Desert Storm, carrying two Marine expeditionary brigades and one Marine expeditionary unit. That total is roughly equivalent to 7 ARGs as they are organized today.

d. Air Force deployment levels are measured in tactical fighter wing equivalents (TFEs). Each TFE represents a force with sufficient aircraft to ensure that 72 combat planes can be sustained and supported. Fractional numbers of TFEs represent additional squadron-sized elements (24 combat aircraft sustained and supported). Marine air wings and carrier air wings are not directly comparable with Air Force TFEs because of differences in size and composition.

TABLE 2. UNITED STATES PERSONNEL ASSOCIATED WITH DESERT STORM AND ESTIMATED FOR CBO'S HEAVY GROUND AND HEAVY AIR OPTIONS (In thousands)

Service	Desert Storm	Heavy Ground	Heavy Air
Army			
Active	206	125	55
Reserve	99	88	38
Subtotal	305	213	93
Marine Corps			
Active	87	40	25
Reserve	6	5	0
Subtotal	93	45	25
Navy			
Active	84	63	63
Reserve	1	0	0
Subtotal	85	63	63
Air Force			
Active	47	26	47
Reserve	10	8	13
Subtotal	57	34	60
Special Operations Forces[a]	N.A.	12	12
Total Personnel Deployed			
Active	424	266	202
Reserve	116	101	51
All Personnel	540	367	253
Reserve Backfill[b]	115	72	55
Total Personnel Required			
Active	424	266	202
Reserve	231	173	106
All Personnel	655	439	308

SOURCE: Congressional Budget Office.

NOTE: N.A. = not available.

a. Special-operations forces (SOF) personnel are not displayed by service for the Heavy Ground and Heavy Air options because all SOF forces are managed, funded, and provided by Special Operations Command.

b. Personnel required for backfill would not deploy to the theater of operations but would instead fill stateside or other positions left vacant by deploying active-duty troops.

TABLE 3. ESTIMATED COSTS OF DEPLOYMENT TO, COMBAT OPERATIONS IN, AND OCCUPATION OF IRAQ: HEAVY GROUND FORCE OPTION (In billions of 2003 dollars)

Cost Element	Deployment (Three months)	First Month of Combat[d]	Subsequent Months of Combat[e] (Per month)	Redeployment (Three months)	Occupation (Per month)
Personnel and Personnel Support[a]	4.3	1.4	1.4	4.3	n.a.
Operations Support[b]	5.4	7.1	5.4	1.5	n.a.
Transportation[c]	2.8	0.7	0.7	1.5	n.a.
Total	12.5	9.2	7.5	7.3	1.4 to 3.8[f]

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

a. "Personnel" includes pay for reserve personnel called to active duty as well as special payments, such as hazardous duty pay, for both reserve and active-duty personnel. The category also covers subsistence items, such as food and water. CBO's estimate also includes those costs for reserve and National Guard personnel called to active duty in support of the Persian Gulf operations and to fill in for positions left vacant by troops deploying to the Gulf. "Personnel support" includes clothing and personal items as well as medical support.

b. This category includes all incremental costs related to the operation and maintenance of air, land, and sea forces involved in the Persian Gulf conflict. It includes costs associated with the incremental increase in flying hours and steaming days, such as costs for increased fuel consumption and repair parts. Operations support also includes the costs of equipping and maintaining ground troops and purchasing equipment, as well as the costs associated with command, control, communications, and intelligence. In addition, the category covers force reconstitution, which includes the replacement of munitions stocks and repair or replacement of damaged equipment—and the incremental cost of increased depot maintenance for items such as aircraft, tanks, and ships.

c. "Transportation" includes the cost of moving personnel and equipment to the theater of operations from the continental United States and from bases around the globe. Those costs are incurred by the U.S. Transportation Command, which operates DoD's heavy-lift aircraft, Navy sealift, and contracts for commercial air and shipping.

d. CBO assumes that in the first month of combat, 50 percent of the targets will be attacked by precision-guided munitions (PGMs).

e. CBO assumes that if combat operations continue beyond one month, 10 percent of the targets would be attacked by PGMs.

f. This estimate is based on an average cost per U.S. Army peacekeeper for occupation forces ranging from 75,000 to 200,000 peacekeepers. The estimate could be significantly larger if the occupation included heavy construction, such as building bases, bridges, and roads. If the United States limited its role to providing logistical support to other nations' occupying forces, costs could be significantly lower.

TABLE 4. ESTIMATED COSTS OF DEPLOYMENT TO, COMBAT OPERATIONS IN, AND OCCUPATION OF IRAQ: HEAVY AIR FORCE OPTION (In billions of 2003 dollars)

Cost Element	Deployment (Three months)	First Month of Combat[d]	Subsequent Months of Combat[e] (Per month)	Redeployment (Three months)	Occupation (Per month)
Personnel and Personnel Support[a]	2.7	0.9	0.9	2.7	n.a.
Operations Support[b]	4.2	6.2	4.7	1.1	n.a.
Transportation[c]	1.9	0.5	0.5	1.0	n.a.
Total	8.8	7.6	6.1	4.8	1.4 to 3.8[f]

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

a. "Personnel" includes pay for reserve personnel called to active duty as well as special payments, such as hazardous duty pay, for both reserve and active-duty personnel. The category also covers subsistence items, such as food and water. CBO's estimate also includes those costs for reserve and National Guard personnel called to active duty in support of the Persian Gulf operations and to fill in for positions left vacant by troops deploying to the Gulf. "Personnel support" includes clothing and personal items as well as medical support.

b. This category includes all incremental costs related to the operation and maintenance of air, land, and sea forces involved in the Persian Gulf. It includes costs associated with the incremental increase in flying hours and steaming days, such as costs for increased fuel consumption and repair parts. Operations support also includes the costs of equipping and maintaining ground troops and purchasing equipment, as well as costs associated with command, control, communications, and intelligence. In addition, the category covers force reconstitution, which includes the replacement of munitions stocks and repair or replacement of damaged equipment, and the incremental cost of increased depot maintenance for items such as aircraft, tanks, and ships.

c. "Transportation" includes the cost of moving personnel and equipment to the theater of operations from the continental United States and other bases around the globe. Those costs are incurred by the U.S. Transportation Command, which operates DoD's heavy-lift aircraft, Navy sealift, and contracts for commercial air and shipping.

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e. CBO assumes that if combat operations continue beyond one month, 10 percent of the targets would be attacked by PGMs.

f. This estimate is based on an average cost per U.S. Army peacekeeper for occupation forces ranging from 75,000 to 200,000 peacekeepers. The estimate could be significantly larger if the occupation included heavy construction, such as building bases, bridges, and roads. If the United States limited its role to providing logistical support to other nations' occupying forces, costs could be significantly lower..

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Douglas Holtz-Eakin, Director

February 7, 2003

The Honorable Don Nickles
Chairman
Senate Committee on the Budget
United States Senate
Washington, DC 20510

Dear Mr. Chairman,

Enclosed are the Congressional Budget Office's responses to questions raised at the Committee's hearing on the Budget and Economic Outlook on Thursday, January 30, 2003, and to follow-up questions received from your office.

Please contact me at (202) 226-2700 if you have any questions or concerns.

Sincerely,

Barry B. Anderson
Deputy Director

Enclosures

cc: Honorable Pete Domenici
Honorable Charles Grassley
Honorable Judd Gregg
Honorable Wayne Allard
Honorable Conrad Burns
Honorable Michael Enzi
Honorable Jeff Sessions
Honorable Jim Bunning
Honorable Michael Crapo
Honorable John Ensign
Honorable John Cornyn
Honorable Kent Conrad
Honorable Ernest Hollings
Honorable Paul Sarbanes
Honorable Patty Murray
Honorable Ron Wyden
Honorable Russell Feingold
Honorable Tim Johnson
Honorable Robert Byrd
Honorable Bill Nelson
Honorable Debbie Stabenow
Honorable Jon Corzine

Material Submitted by the Congressional Budget Office to Accompany the Statement of Barry B. Anderson Before the Senate Committee on the Budget, January 30, 2003

Answers to Questions from Chairman Nickles

Question. What is the percentage allocation between legislative and economic/technical reasons when looking at the change in the surplus projections from January 2001?

Answer. For 2002, CBO estimates that economic and technical factors accounted for 68 percent of the change from the projection made in January 2001. For 2003, that share declines to 55 percent. For the 2002-2011 period, CBO estimates that 46 percent of the diminished projections of the surplus result from economic and technical revisions and 54 percent from legislative action (see table below).

Changes in CBO's Baseline Projections from January 2001 to January 2003
(In percent)

	2002	2003	2002-2011
Legislation			
EGTRRA[a]	8	16	23
Other revenue	9	8	1
Discretionary	11	14	15
Mandatory	3	5	3
Debt service	1	3	13
Subtotal, legislation	32	45	54
Economic and Technical	68	55	46
Total	100	100	100

SOURCE: Congressional Budget Office.

a. The Economic Growth and Tax Relief Reconciliation Act of 2001.

Question. Why does the debt ceiling cover both debt held by the public and debt held by government accounts?

Answer. The current concept of a limit on Treasury debt originated in the Second Liberty Bond Act of 1917, which allowed the Treasury to borrow as necessary up to a specified ceiling set by the Congress to fund federal activities. The definition of debt subject to limit was broadened over the next two decades and reached its current consolidated form in the early 1940s. Both debt held by the public and debt held by government accounts fall under the debt ceiling; the sum of those two types of Treasury debt is currently slightly below the $6.4 trillion ceiling.

When the original concept of a limit on public debt was established in 1917, debt held by government accounts did not exist. By 1940—when the debt limit was being shaped into its current form—the amount of such debt was small. At the end of 1940, debt held by government accounts totaled less than $8 billion (about 16 percent of all outstanding debt). Today, debt held by government accounts (mostly trust funds) represents over 40 percent of the total outstanding debt, or more than $2.6 trillion.

In 1967, the President's Commission on Budget Concepts examined the debt limit in the context of its other proposals. The Commission did not endorse a public debt ceiling as a means of controlling the budget; however, it did suggest that the limit could be confined to direct borrowing of the U.S. Treasury.

Answer to Question from Senators Crapo and Stabenow

Question. What would CBO's adjusted baseline look like if all expiring revenue provisions were extended?

Answer. If all expiring revenue provisions were extended (but no other policies affecting the budget were changed), CBO projects that the resulting baseline would still show deficits that decline and eventually turn to surpluses; however, the level of future surpluses would be much smaller than projected under CBO's adjusted baseline (see table below).

Effect on CBO's Adjusted Baseline if All Expiring Revenue Provisions Were Extended
(In billions of dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
Total Deficit (-) or Surplus Under CBO's Jan. 2003 Adjusted Baseline[a]	-199	-145	-73	-16	26	65	103	140	277	451	508	-143	1,336
Effect on Deficit or Surplus of Extending All Expiring Revenue Provisions													
Revenues	*	*	-34	-61	-69	-73	-74	-76	-206	-308	-321	-237	-1,222
Debt service	*	*	-1	-4	-7	-12	-16	-21	-30	-45	-65	-23	-200
Subtotal	*	*	-35	-65	-76	-84	-90	-97	-236	-353	-386	-261	-1,423
Resulting Total Deficit (-) or Surplus	-199	-145	-108	-81	-50	-19	13	43	41	98	122	-404	-86

SOURCE: Congressional Budget Office.

NOTE: Assumes that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

* = between -$500 million and zero.

Answer to Question from Senator Allard

Question. What is the stimulative impact of the 2001 tax cuts on the economy?

Answer. The *Economic Growth and Tax Relief Reconciliation Act* of 2001 increased demand during the recession. The tax cuts were well timed, and they helped prevent the economy from slowing more than it did in 2001 and 2002.

CBO analyzed the short-run impact on demand of the tax legislation using two economic models developed by private forecasting firms. One of the important factors in the analysis is how the tax cut affected the Federal Reserve's decisions about monetary policy. If, without the tax cut, the Federal Reserve would have responded to changes in inflation and real output as it has in the past, the models suggest that the tax cut may have increased real gross domestic product by 0.2 percent to 0.4 percent in 2001 and by about 0.5 percent in 2002. That effect implies 100,000 to 300,000 additional jobs in 2001 and about 600,000 in 2002.

Because the tax cut added to demand in the economy, the Federal Reserve did not have to be as aggressive as it otherwise would have been. To achieve the same growth in employment as the tax cut provided, the models suggest that interest rates would have to have been about half a percent lower throughout 2001 and 2002.

Answers to Questions from Chairman Nickles' Office

Medicare

Question. There is broad support in Congress to include a new outpatient drug benefit in the Medicare program and strengthen and improve the underlying program for seniors. Expanding the entitlement on the benefit side, however, comes at a time when Medicare's existing long-term obligations are grossly underfunded. It has been estimated that Medicare's long term unfunded liability over 75 years is $13 trillion.

Part 1. What impact will adding a prescription drug benefit to the Medicare program have on the unfunded long-term liability or have on Medicare's share of GDP?

Answer. The unfunded liability that you mention is consistent with the figures contained in the most recent version of the Treasury Department's *Financial Report of the United States Government*. According to that report, which compares the present value of expected benefit payments to the present value of contributions and earmarked taxes over 75 years, the net shortfall for Medicare totals $12.8 trillion—about $4.7 trillion for Medicare Part A and $8.1 trillion for Medicare Part B.

The effect of adding a prescription drug benefit to Medicare on that unfunded liability would depend on how the benefit was funded. If, as in most recent proposals, general revenues were used to cover the difference between the program's total payments and beneficiaries' contributions of premiums—as is the case with Part B today—then Medicare's unfunded liability would increase by an amount equal to the present value of net federal costs for the new benefit over the next 75 years. Especially if long-term prescription drug spending continued rising more quickly than Medicare costs under current policies, the unfunded liability of such a prescription drug benefit proposal could be quite large. Alternatively, if certain taxes were earmarked to cover the costs of the drug benefit—as with Part A—then the present value of those projected tax revenues would be counted as funding the costs of the drug benefit in whole or in part, thereby reducing—or potentially eliminating—the unfunded liability associated with the new benefit.

Focusing on such measures of unfunded liabilities may, however, mask the size of the federal commitment because the unfunded liability depends on both what size the proposed drug program is and whether tax revenues are earmarked to cover its costs. An alternative measure of the federal commitment assesses the program's projected costs as a share of the economy, since that measure indicates how increases in taxes, cuts in spending on other federal programs, or growth in federal borrowing needed to accommodate projected Medicare spending would affect the economy. CBO projects that under current policies, Medicare spending will grow from 2.4 percent of GDP today to 4.7 percent in 2030 and 9.2 percent in 2075. However, CBO has not projected prescription drug costs over the long run. Proposals from last year to add a drug benefit would have increased Medicare costs by at least 10 percent, and sometimes much more, over the 10-year budget window.

Question. Part 2. What is the outlook over the next 30 years as the baby boomer generation impact is felt on the program?

Answer. As mentioned, according to CBO's projections, Medicare spending will grow from 2.4 percent of GDP today to 4.7 percent in 2030 if current policies remain in place. The demographics are inexorable: the number of Medicare beneficiaries will nearly double by 2030, while the workforce will grow by about 15 percent. Those demographic pressures are compounded by two factors: Medicare beneficiaries use significantly more health care, on average, than the rest of the population, and costs per Medicare enrollee will continue to grow much faster than the economy as a whole.

As a result, projected federal spending on the elderly and disabled through the main federal entitlement programs—Social Security, Medicare, and Medicaid—will reach 14 percent of GDP by 2030, nearly double its current share of the economy. The increased share of GDP that those programs alone will claim in 2030 is almost equal to the share of GDP currently devoted to all federal discretionary spending. Beyond 2030, those fiscal pressures will intensify as longevity continues to increase and health costs continue to grow. The projected growth in spending will require significant increases in taxes, severe cuts in spending on other federal programs, or substantial growth in federal borrowing.

Question. Part 3. Last year, CBO's drug spending baseline assumed Medicare beneficiaries will spend $1.8 trillion for the ten-year period 2003-2012. How much has CBO's drug spending baseline increased?

Answer. CBO recently updated its estimate for prescription drug spending by and on behalf of Medicare beneficiaries, taking into account recent information and reflecting other steps that CBO has taken to improve its projections. Currently CBO projects that Medicare beneficiaries will use $1.84 trillion worth of drugs from 2004 to 2013. That estimate represents an increase of about 4 percent over the projection of $1.77 trillion in drug spending that CBO made last year (covering the years 2003 to 2012).

Shifting out the 10-year budget window is the main reason for that increase because it adds a relatively expensive year (2013) to the projection while dropping a relatively inexpensive year (2003). Indeed, that shift in the projection period would by itself tend to cause a larger increase in CBO's baseline. This year's projection reflects a somewhat smaller increase for two reasons, both of which take into account new information about drug spending. First, new analysis of the degree to which drug spending is underreported in current surveys led CBO to use a slightly smaller underreporting factor in its estimates; the effect of that change is to reduce the starting point for the projection. Second, CBO has decreased slightly its estimate of future growth rates for drug spending in the United States as a whole since last year, owing in part to slower-than-expected economic growth in the near term. It is worth noting, however, that the estimated cost of a specific Medicare drug benefit proposal from last year (but with effective dates delayed by one year) could change by more or less than the change in CBO's baseline projection of drug spending, depending on the details of the proposal.

Health Care

Question. The Centers for Medicare and Medicaid Services reported that health care expenditures increased 8.7% between 2000 and 2001, the fastest rate of growth in ten years. Health care expenditures consume roughly 14% of our Nation's output. Most of the growth is attributed to increased demand for hospital stays, outpatient services, and prescriptions rather than rising prices.

Healthcare expenditures are strongly correlated with the growth of our nations aging population. As the baby boom generation approaches retirement, what long-term challenges does this pose for the Federal Budget?

Answer. Without changes to federal programs for the elderly, the aging of the baby-boom generation will cause a substantial deterioration in the United States' fiscal position. As noted, the number of Medicare beneficiaries will nearly double by 2030, while the workforce will grow by about 15 percent. For Medicare and Medicaid, those demographic pressures are compounded because costs per enrollee are projected to continue growing much faster than the economy as a whole.

As a result, projected federal spending on the elderly and disabled through the main federal entitlement programs—Social Security, Medicare, and Medicaid—will reach 14 percent of GDP by 2030, nearly double its current share of the economy. Far from abating, those fiscal pressures will intensify thereafter as longevity continues to increase and health costs continue to grow. As stated earlier, projected growth in spending will require significant increases in taxes, severe cuts in spending on other federal programs, or substantial growth in federal borrowing.

EGTRRA and Economic Growth

On page 26 of the Budget and Economic Outlook: Fiscal Years 2004-2013, Box 2-1 reads, "On net, CBO estimates, [that] the expiration of EGTRRA will lower GDP by about a half a percent by 2013. . . . [T]he largest economic effects of the higher tax rates are likely to involve labor supply, which may shrink by between 0.4 percent and 1.2 percent from what it would have other wise been. . . . The economic weakening caused by even so large a tax increase could reduce revenue by about $40 billion: $6 billion in 2011, $15 billion in 2012, and $18 billion in 2013."

Question. Do you agree that marginal tax rate cuts act as incentive for individuals to work harder and save and invest more?

Answer. Yes.

Question. If raising tax cuts can lower economic output, do you believe that the opposite, lowering taxes on labor and capital can stimulate economic activity?

Answer. Yes, though the effect depends on how the tax cut is financed.

Need to Increase the Debt Limit

Question. Late last year, Treasury Deputy Secretary Dam sent a letter to Congress asking for an increase in the statutory debt ceiling. CBO's new baseline indicates that we would need to increase the current debt ceiling by about $1 trillion to carry the government through fiscal 2005.

Part 1. Over the same period, debt held by the public is projected to increase by about $500 billion. That being the case, why would Congress need to raise the debt ceiling by $1 trillion?

Answer. From 2002 to 2005, CBO's baseline projects that debt held by the public will increase by about $475 billion. Raising the debt limit by that amount would be insufficient because it would neglect intragovernmental holdings, the other main component of debt subject to limit. In the baseline, those securities are projected to increase by about $745 billion from the end of 2002 to the end of 2005.

Question. Part 2. What does the current debt ceiling cover? What is the difference between debt held by the public and debt subject to limit?

Answer. The ceiling covers both debt held by the public and debt held by government accounts. It does not include debt issued directly by agencies (which totaled about $37 billion at the end of 2002).

Debt held by the public includes all federal debt held by individuals, corporations, state or local governments, foreign governments, and other entities outside of the U.S. government. Debt subject to limit is the maximum amount of money that the government is allowed to borrow without receiving additional authority from the Congress. The primary difference between debt held by the public and debt subject to limit is that the latter also includes debt held by government accounts.

Question. Part 3. Does it make sense to have a limit on debt which includes intragovernmental obligations? Should the debt limit just cover debt held by the public?

Answer. Many analysts argue that a debt ceiling should not apply to intragovernmental obligations. Instead, they maintain, the debt ceiling should focus on debt held by the public—that is, the amount borrowed to finance deficits. Such borrowing is the concern of economists, participants in financial markets, and others who worry about the federal government's demand on credit markets. The President's Commission on Budget Concepts in 1967 proposed a more refined measure of debt held by the public and urged that the statutory limit on federal debt be revised accordingly.

Question. Part 4. If the limit covered just debt held by the public, what would that figure be?

Answer. At the end of 2002, debt held by the public equaled $3.540 trillion. Under the assumption that current policies remain the same, CBO projects that debt held by the public will rise to about $4 trillion by the end of 2005.

Highways

Question. TEA-21 was authorized from 1998-2003. With the expiration of TEA-21 on September 30, 2003, what will CBO be using for a baseline beyond 2003?

Answer. The Deficit Control Act prescribes the method that CBO uses to project budgetary resources in its baseline, including both discretionary and mandatory resources for programs authorized under TEA-21.

To project discretionary resources, CBO begins with the budget authority and obligation limits provided in the most recent appropriations act. CBO adjusts the figures for inflation in each of the following years of the baseline period. Using that method, CBO projects obligation limitations and spending for the Federal-Aid Highway program and certain other programs authorized by TEA-21 well beyond 2003, the year that TEA-21 expires.

The current continuing resolution, P.L. 108-004, would provide $33.8 billion in discretionary resources for fiscal year 2003 if it was in effect for the rest of the year.

To project mandatory resources, CBO's baseline includes the contract authority provided by current law. The Deficit Control Act, however, specifies that CBO's baseline assume that large mandatory programs scheduled to expire during the baseline period continue to operate at the same level anticipated for the year they expire. For that reason, CBO's baseline continues the 2003 level of contract authority for transportation programs, including the Federal-Aid Highway program, for each year of the baseline period.

If a program with contract authority, such as the Federal-Aid Highway program, has expired by the time CBO prepares its next baseline, then CBO will not include that authority in the baseline projections. That is, if TEA-21 expires at the end of this fiscal year, then CBO will not project any contract authority for TEA-21 in its January 2004 baseline. At that point, however, CBO would still project discretionary resources by adjusting the 2003 obligation limits for TEA-21 programs for inflation and estimating the resulting spending.

TEA-21 provided $37.5 billion in contract authority for fiscal year 2003.

Medicaid

Question. Part 1. According to your new baseline, Medicaid outlays grew by 13.2 percent last year, marking the sixth consecutive year that spending growth in the program accelerated. You predict that as Medicaid spending continues to grow, it will overtake Medicare spending in the next few years.

How much of this spending is for optional services and benefits?

Answer. On the basis of work done several years ago by the Congressional Research Service, CBO estimates that about 60 percent of Medicaid benefit spending is for either optional benefits or services furnished to beneficiaries in optional coverage groups.

Question. What is fueling the 13.2 percent increase in Medicaid spending?

Answer. The increase in Medicaid spending of 13.2 percent in 2003 was due to several factors:

- Caseloads increased as states' expansions of eligibility enacted in 2000 and 2001 took effect. Many of those expansions were for parents of children enrolled in Medicaid.

- Higher unemployment led to additional enrollment of poor children and adults.

- Higher spending occurred for all types of benefits because of medical cost inflation and higher utilization of services.

- Spending on prescription drugs grew by 18 percent.

- States continued to use upper payment limit (UPL) financing mechanisms to get extra federal funding.

Although a few states acted to reduce Medicaid spending in 2002—primarily by trimming payment rates for services—those actions were not substantial enough to counter other factors.

Question. Part 2. In your analysis of increasing costs to Medicaid, you have indicated that financing mechanisms such as the upper payment limit (UPL) contribute to larger federal payments. As a member of the Finance Committee, I have worked with Chairman Grassley to restrict these types of abuses.

Is there more room to clamp down on UPL and are their other areas of payment diversion Congress should be looking into?

Answer. States' ability to use the UPL mechanism is much more limited than it was a few years ago. CBO projects that federal spending related to UPL mechanisms will decline from about $5.5 billion in 2003 to $2.8 billion in 2009 as recent legislative and regulatory changes to restrict those payments take effect. By 2013, that spending will rise to S3.5 billion. According to CBO's estimates, over the 2004-2013 period, federal costs associated with the UPL mechanism will total $34 billion. CBO is not aware of other types of diversions of payments at this time.

Cost of a War with Iraq

Question. Last September, CBO estimated the cost of a potential war with Iraq. CBO noted that the cost of a conflict and its aftermath were highly uncertain.

Part 1. Recognizing these uncertainties, how might a potential conflict with Iraq affect the budget outlook?

Answer. Recently, CBO was asked to gauge the costs of activities related to possible military operations in Iraq. (See the enclosed letter to Senator Kent Conrad and Congressman John M. Spratt, Jr., on September 30, 2002, *Estimated Costs of a Potential Conflict with Iraq* which also is available at www.cbo.gov.) CBO concluded, as you state, that estimates of the total cost of a military conflict with Iraq and such a conflict's aftermath are highly uncertain. They depend on many factors that are unknown, including the size of the force that is deployed, the strategy to be used, the duration of the conflict, the number of casualties, the equipment lost, and the need for reconstruction of Iraq's infrastructure.

Of the many force levels that might be used to prosecute such a war, CBO examined two representative examples. Both alternatives were based to some extent on the forces that the Department of Defense had previously indicated it would require for a major theater war. The first of CBO's examples emphasized U.S. ground forces. That so-called Heavy Ground option would include about five Army divisions and five Air Force tactical fighter wings. The second option relied more on air power. Termed the Heavy Air option, it would comprise two and one-third Army divisions and 10 Air Force tactical fighter wings. Using those assumptions, CBO employed various methods to develop its estimates, including the use of data on the cost of prior and current military operations—most notably, those in the Balkans, Afghanistan, and Desert Shield/Desert Storm.

Using those two examples, CBO estimated that the incremental costs of deploying a force to the Persian Gulf (that is, the costs that would be incurred above those budgeted for routine operations) would be between $9 billion and $13 billion. Prosecuting a war would cost between $6 billion and $9 billion a month—although how long such a war might last could not be estimated. After hostilities ended, the costs to return U.S. forces to their home bases would range between $5 billion and $7 billion, CBO estimated. Further, the incremental cost of an occupation following combat operations would vary from about $1 billion to $4 billion a month. CBO had no basis for estimating any costs for reconstruction or for foreign aid that the United States might choose to extend after a conflict had ended. The following table summaries those estimates.

Estimated Cost of Military Operations in Iraq by Phase and Size of Force (In billions of 2003 dollars)

Force Structure	Deployment (Three months)	First Month of Combat	Subsequent Months of Combat (Per month)	Redeployment (Three months)	Occupation (Per month)
Heavy Ground[a]	12.5	9.2	7.5	7.3	1.4 to 3.8
Heavy Air[b]	8.8	7.6	6.1	4.8	1.4 to 3.8

SOURCE: Congressional Budget Office.

a. The estimate for the "Heavy Ground" force structure assumes five U.S. Army divisions and five U.S. Air Force tactical fighter wings.

b. The estimate for the "Heavy Air" force structure assumes two and one-third U.S. Army divisions and 10 U.S. Air Force tactical fighter wings.

Many alternative force structures—other than the two options that CBO used in its estimates—could be fielded. And whatever forces were used, multiple unknown factors would characterize any scenario of how a conflict with Iraq might actually unfold. On the one hand, if the Iraqi leadership or selected elements of its military forces quickly capitulated, ground combat could be of short duration, as in Desert Storm. On the other hand, if the leadership and military chose to fight, Iraq's use of chemical or biological weapons against regional military or transportation facilities could extend the war, as could the need to engage in protracted urban fighting. Given those uncertainties, CBO's estimates of the monthly costs of operations exclude expenditures for decontaminating areas or equipment affected by chemical or biological attacks.

A war in Iraq could lead to substantial costs in later years that were not included in CBO's estimates, either because their magnitude could not be assessed even roughly or because they depended on highly uncertain decisions about future policy. For example, the United States might leave troops or equipment in Iraq, which could require the construction of new military bases. Sustaining the occupation over time could require either increases in overall active-duty and reserve force levels or major changes in current policies on basing and deployment. The United States might provide Iraq with funds for humanitarian assistance and reconstruction. And it might provide substantial aid in the future to allies and other friendly nations in the region.

Question. Part 2. How do CBO's cost estimates of a war with Iraq compare with the estimates of others?

Answer. CBO's estimates are for the incremental monthly costs associated directly with combat and occupation. Because of the many uncertainties regarding how a conflict might unfold, CBO has not estimated potential total costs for combat and occupation. Nor has CBO considered other costs, such as those for reconstruction of infrastructure in Iraq and foreign aid or the costs associated with the indirect effects of a war on the U.S. economy. Estimates that other organizations have made tend to focus on the total potential cost, including many assumptions and effects that CBO's estimates exclude. Therefore, although many of the estimates of the cost of a war in Iraq that others have made make use of CBO's results, none are directly comparable to CBO's estimates.

Question. Part 3. It is possible that U.N. weapons inspections in Iraq could take longer that initially thought. If this is the case, U.S. military forces may have to be maintained in a "stand-by" posture for the foreseeable future. What is the cost of keeping sufficient forces stationed in the region indefinitely until a decision is made whether to go to war?

Answer. In CBO's September estimate of the potential cost of a war with Iraq, the cost for a three-month deployment phase was between $9 billion and $13 billion, depending on the size of the force. Given the current situation, it's difficult to determine when exactly that three-month period begins and ends. In fact, the deployment phase may be shorter or longer than three months. An important factor in determining the cost of the deployment phase will be the activation of reserve and national guard units, which has not yet happened to the degree assumed in CBO's estimate. However, if the Heavy Ground or Heavy Air forces assumed in CBO's estimates (which would be about 300,000 to 440,000 personnel) are completely deployed, then CBO estimates that keeping those forces in the region on a sort of "stand-by" status would cost between $3 billion and $4 billion a month.

Answer to Question from Senator Crapo

Question. What are the costs of a possible war with Iraq?

Answer. Following is the September 2002 CBO report *Estimated Costs of a Potential Conflict with Iraq.*

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON THE BUDGET
CBO'S BUDGET AND ECONOMIC OUTLOOK
JANUARY 30, 2003

Thank you, Mr. Chairman.

I was concerned, as I'm sure were most members of this Committee, to read that new CBO estimates of a $199 billion budget deficit for fiscal 2003. This number brings into the stark reality the magnitude of the job before us in this Committee and in this Congress – we must do what we can to help get our economy back on track and we must hold the line on spending.

I can think of no better way to boost our economy than to allow the taxpayers to keep more of the money that they earn. I firmly believe that we have the most vibrant economy in the world and that is the result of the dedication of the workers and the businesspeople of this country. One of our challenges is to remember that all wisdom does not stem from Washington -- it most certainly does not. The families and the business men and women of this country are the best judges of how to best support their children and grow their businesses. In many cases – in most cases -- we can best serve the American people and the American economy by getting out of the way.

This Committee often has the job of trying to provide the Senate with some level of fiscal restraint This will be a very challenging year for us on this Committee, but I am confident that under the leadership of Chairman Nickles, doing what we can to get control on the spending will continue to be a priority.

I thank Mr. Anderson and his staff for their hard work and dedication and for his willingness to appear before us today to explain the analysis of his office in detail.

Thank you.

Changes in CBO's Baseline Projections of the Surplus Since January 2001
January 2003 Adjusted Baseline
(by fiscal year, in billions of dollars)

	2002	% of total	2003	% of total	Total, 2002 - 2011	% of total
Total Surplus as Projected January 2001	313		359		5,610	
Bipartisan Bush tax cut	(31)	7%	(84)	15%	(1,186)	21%
Bipartisan economic stimulus tax cut	(43)	9%	(39)	7%	(35)	1%
Other tax changes	(1)	0%	(3)	1%	(21)	0%
SUBTOTAL, TAX CUTS	(75)	16%	(126)	23%	(1,242)	22%
Discretionary spending increases	50	11%	77	14%	818	15%
Mandatory spending increases	25	5%	48	9%	953	17%
SUBTOTAL, NEW SPENDING	75	16%	126	23%	1,771	32%
ECONOMIC & TECHNICAL REESTIMATES	(321)	68%	(306)	55%	(2,577)	46%
TOTAL CHANGES	(471)	100%	(558)	100%	(5,590)	100%
Total Surplus/Deficit as Projected in January 2003	(158)		(199)		20	
NOTE: Surplus or deficit without any legislative changes	(8)		53		3,244	

SOURCE: Congressional Budget Office.

THE PRESIDENT'S FISCAL YEAR 2004 BUDGET

TUESDAY, FEBRUARY 4, 2003

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

The committee met, pursuant to notice, at 2:04 p.m., in room SD–608, Dirksen Senate Office Building, Hon. Don Nickles (chairman of the committee) presiding.

Present: Senators Nickles, Enzi, Sessions, Conrad, and Corzine.

Staff present: Hazen Marshall, staff director; and Cheri Reidy, senior analyst.

For the minority: Mary Ann Naylor, staff director; and Lee Price, chief economist.

OPENING STATEMENT OF CHAIRMAN DON NICKLES

Chairman NICKLES. We will convene the hearing. Dr. Hubbard, welcome. We are delighted to have you before our committee. We are delighted, as well, that Senator Enzi is with us.

I will apologize and mention that because of the recent tragedy, there are several of our members that are attending the memorial services, and our hearts, and prayers, and sympathies are certainly with the victims and their families of this recent disaster. I observed the memorial service, the President and others, we have several of our colleagues that are present, and we decided to go ahead and conduct the hearing today.

Dr. Hubbard, we welcome you to our committee. We are pleased that you would join us and pleased as well that my friend and colleague, Ranking Member Senator Conrad is with us as well.

Senator Conrad, do you have any opening comments?

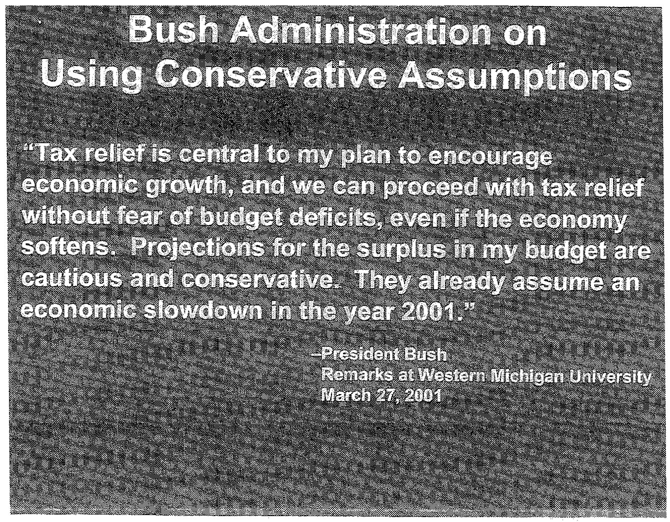
OPENING STATEMENT OF SENATOR CONRAD

Senator CONRAD. First of all, Mr. Chairman, I want to join you in saying that our minds are very much with the family members, and we are thinking very much about those who lost their lives. It is an incredible tragedy, and I think the Chairman was right to go ahead with the business of the Committee because, after all, this deals with issues that affected those who gave their lives. So I think the Chairman was quite right in proceeding, and we certainly welcome Dr. Hubbard here.

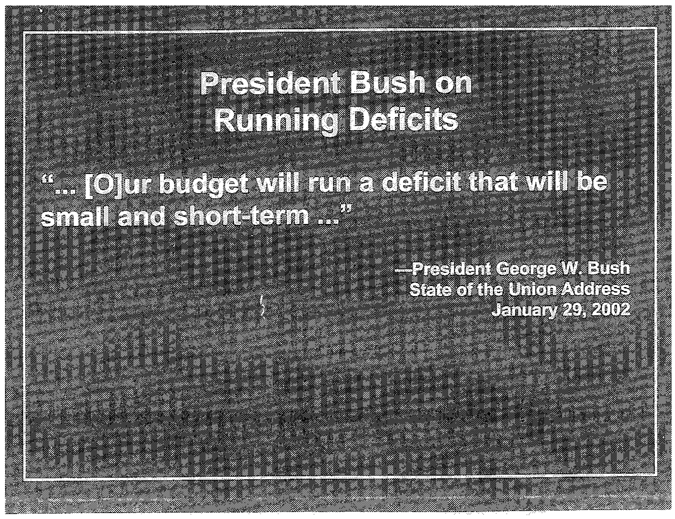
Mr. Chairman, I would start with just a brief review of where we are from my perspective, and where we are headed, and why this all matters a lot.

The President said in 2001 that he was using conservative economic assumptions. He said, "Tax relief is central to my plan to encourage economic growth, and we can proceed with tax relief without fear of budget deficits. Even if the economy softens, projections for the surplus in my budget are cautious and conservative. They already assume an economic slowdown in the year 2001."

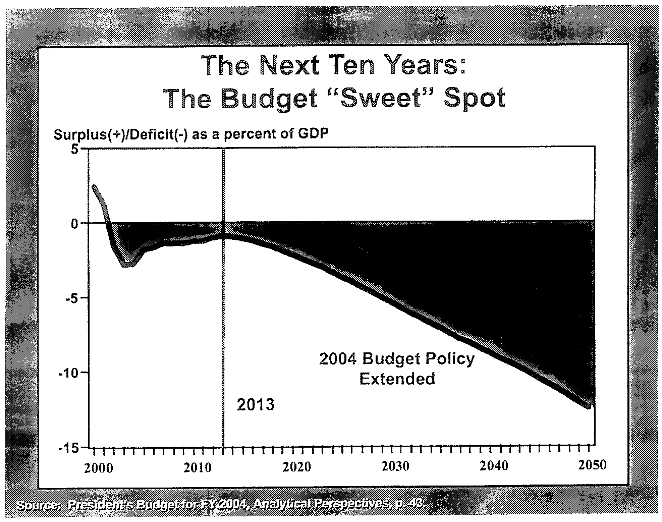
Well, we now know, with the President's release of the budget, that those statements really missed the mark. We were told that we were going to have nearly $6 trillion over the next decade in surpluses. In the President's most recent information, that has turned to $2.1 trillion in deficits, a truly dramatic turn, approaching $7.8 billion over the next decade.

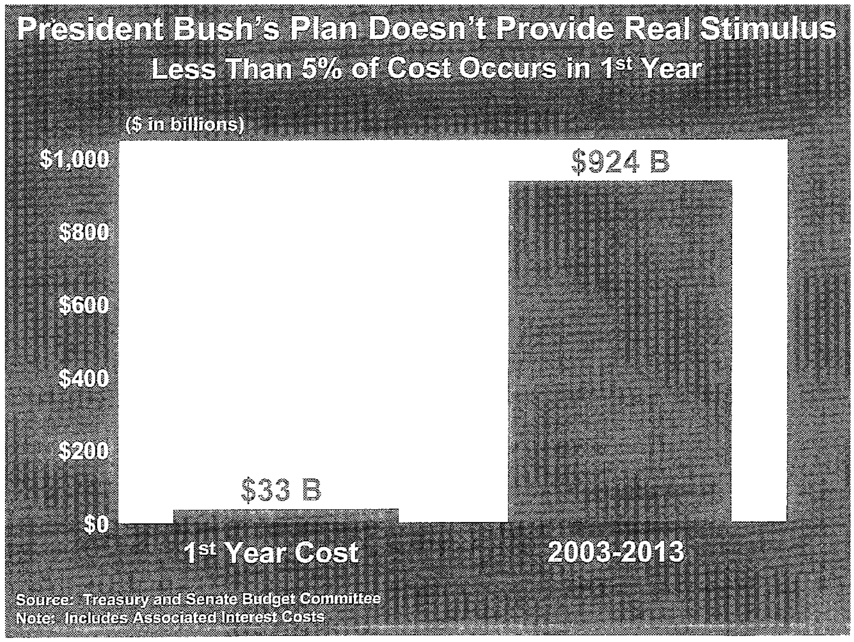


Let us go to the next. Last year, the President said our budget will run a deficit that will be small and short term. Well, again, he missed the mark, and the reality of our situation is much more stark. This, again, is from the President's own documents that show that we are actually, even though we are running record deficits now, those deficits on the left-hand side of the chart are record. They are the biggest in dollar terms we have ever had. The President's own information shows that if we pursue this budget policy, we never get out of deficit, and in fact they become much larger over time, as the baby boom generation retires.

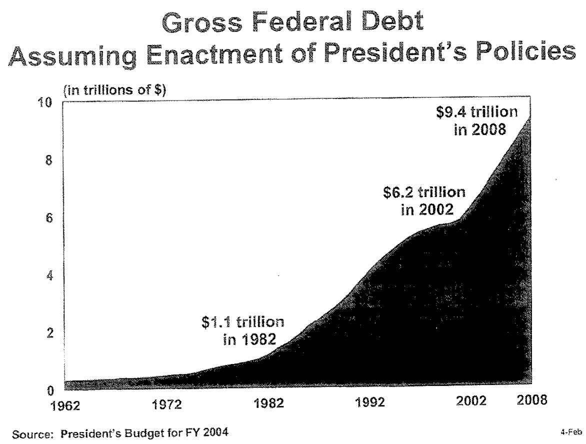


The President, as part of his package, has proposed a stimulus or a growth package, but we see that very little of it, very little of the cost of it is effective in this first year, the first fiscal year. Less than 5 percent of the stimulus plan or the growth plan is effective this year.



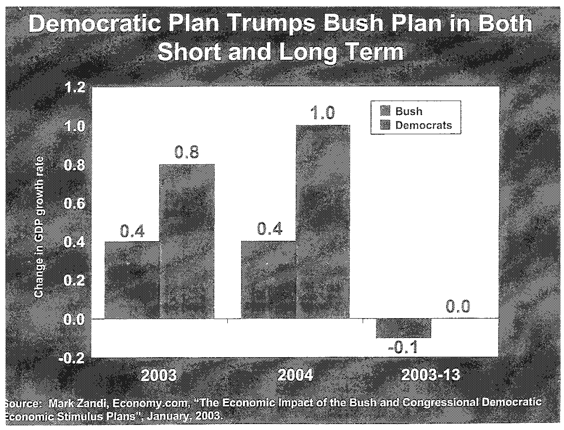

President Bush's Plan Doesn't Provide Real Stimulus
Less Than 5% of Cost Occurs in 1st Year
($ in billions)
$1,000
$800
$600
$400
$200
$0
$33 B
$924 B
1st Year Cost
2003-2013
Source: Treasury and Senate Budget Committee
Note: Includes Associated Interest Costs

The one thing that is growing is the debt, and the debt is growing dramatically. Gross Federal debt will go from $6.2 trillion last year to $9.4 trillion by 2008, a time at which the President had previously indicated we would virtually retire the publicly held debt.



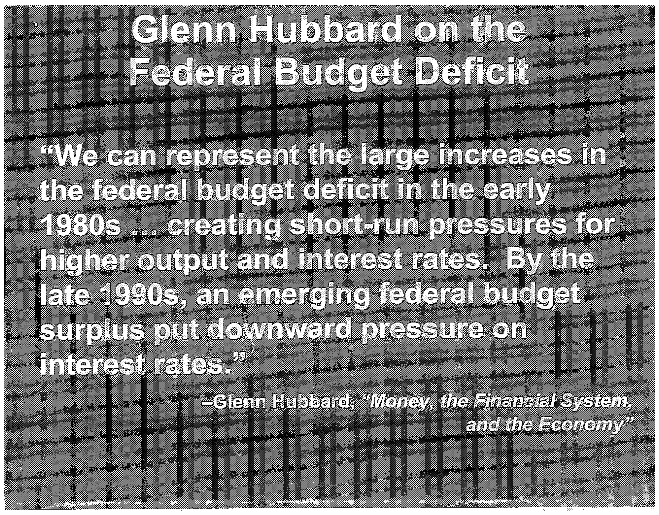
Now, we go to the question of what works in terms of economic growth. The Chairman has been very correct, I think, to point out what we have got to do is get back on an economic growth path. This is from the Macroeconomic Advisers, who I am told provide macroeconomic analysis to the White House, as well as to the Congressional Budget Office. What their estimates show is that the President's policy does provide a spike up in the near term, but past 2005 provides lower economic growth than if we did not do anything at all. It actually hurts economic growth for the long term.

That view is buttressed by Mark Zandi, the chief economist for Economy.com. He says, in 2003, the Democrats plan that provides more short-term stimulus will provide about twice as much economic growth in 2003, little more than twice as much in 2004, but interestingly enough will not provide the long-term harm that the President's plan will have.



Again, he finds, just like the other econometric firm has found, that the President's plan actually hurts long-term growth.

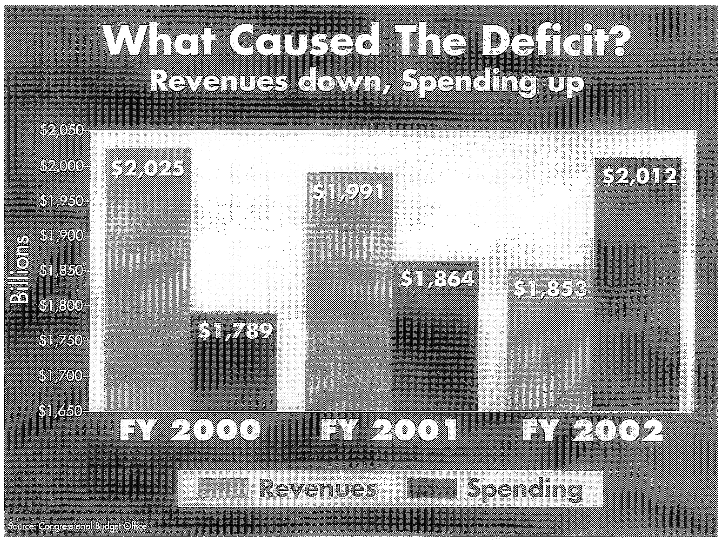
Let me just conclude with a statement from you, Dr. Hubbard, in your textbook. You say, and I quote, "We can represent the large increases in the Federal budget deficit in the early 1980's, creating short-run pressures for higher output and interest rates. By the late 1990's, an emerging Federal budget surplus put downward pressure on interest rates." I would agree with that, and I would suggest that increasing deficits, increasing debt will serve as a drag on the economy. That is what other economists have found; that the dead weight of deficits and debt actually hurt long-term economic growth. That is really what this discussion is about, this debate is about.



We have got to, together, find the strategy that will best help our country return to economic growth, and I thank you, Mr. Chairman, for the hearing.

Chairman NICKLES. Senator Conrad, I will agree with that last statement. I hope that we will work together and find the policies that will help best grow the economy.

I would like to show one chart. I am going to try and avoid chart wars with you. The guy makes charts like they are popcorn. They keep popping up every where I go, Senator Conrad's charts.



I am going to show this chart because this chart kind of shows what happened a little bit, and maybe I will ask Dr. Hubbard to help maybe explain, but the blue is revenues, and you can see revenues in the year 2000 were over $2 trillion—$2.25 trillion. The next year they declined by about 1.7 percent, went down to $1.99 trillion, and then in 2002, declined to $1.853 trillion, a reduction of almost 7 percent from 2001 to 2002, a combined reduction of about 8.5 percent.

Conversely, expenditures climbed dramatically, total outlays of the Federal Government. There was, let me see if I have the percentages, the spending increased between 2000 and 2001 about 4.2 percent and then between 2001 and 2002 by 7.9 percent. Actually, if you took away the reduction in interest costs, spending grew by, well, actually, in the appropriated accounts by over 12 percent.

So you had spending growing dramatically, revenues declining substantially, and, Dr. Hubbard, OMB missed the guess on revenues and so did CBO. You both guessed about the same. I mean, your mistakes were about even. You both misjudged revenues, but I will tell you history has never shown this kind of reduction in revenues. Two consecutive years, we have never had reduction in revenues, and we have certainly never had a reduction in revenues of 7 percent like we saw between 2001 and 2002.

I might note from my colleagues, since the President has proposed a budget of $2.2 trillion, if revenues would have maintained any type of growth for 2001, 2002, 2003, 2004, a growth of 2 percent, and we would still be in balance, but we had a rather dramatic departure in growth and a decline in revenues. At the same time, we also had a big increase in spending.

So, Dr. Hubbard, one of the questions I will ask you—I am going to ask Senator Enzi if he has any opening remarks—but one of the questions I will be asking you is what caused this dramatic reduction of income? There was a stock-market collapse, but how did that flow through? How has that impacted? Why did everybody misjudge the estimates, even in 2001, on total revenues by hundreds of billions of dollars?

We all goofed. OMB goofed, CBO goofed; i.e., Congress, so the Administration and the Congressional Branch both misjudged total revenues by a lot, and so as a result, we are a couple hundred billion dollars behind, and then how do we get out of this mess?

I do not think you can get out unless you grow the economy. You have some proposals. I would like to hear from you today on how you think the Administration's proposals would grow the economy, how they will create equity, how they will increase market values. I think a large part of this reduction in revenues was a result of the stock market decline, and will the proposals that you are advocating, will that increase stock market values?

Before I finish that, I would like to call upon Senator Enzi if he had any opening remarks.

Senator ENZI. I will stay with the new tradition.

Chairman NICKLES. Thank you. I appreciate that.

So, Dr. Hubbard, to introduce you, I will say that you were confirmed by this body on May 10th of 2001, so I guess I should not give you full credit for the estimates that were made in January of 2001, but we are delighted that you are here. You were appointed by the President to be chairman of the Council of Economic Advisers. You also received your Ph.D. in economics from Harvard University in 1983, and you are currently on leave of absence from Columbia University.

You also served as deputy assistant secretary for Tax Analysis at the Treasury Department, which also makes it very important for you to be here, I think, to further explain some of the growth proposals that you have made. So, Dr. Hubbard, we welcome you to our committee. We are delighted to have you here, and we are happy to hear your opening remarks.

STATEMENT OF GLENN HUBBARD, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. HUBBARD. Thank you very much, Mr. Chairman, and Senator Conrad, Senator Enzi.

In my oral remarks, I really just wanted to do three things with you: one, to try to sketch first a sense of long-term prospects for the economy and why I still believe they are very, very bright; second, to talk about the problem that the President was trying to fix in his growth package; and then, third, to talk about benefits of the plan and then come back to some of the budget issues that you and Senator Conrad had raised.

In a sense, we start out with a very complicated time, not just for budgeting forecasting, but for thinking about the economy. The recession we went through and the recovery that we are now in are very atypical. We had not only an investment collapse leading this business cycle, which is very unusual, but of course we had the terrible events of September 11th, and corporate governance scandals as well.

That is not just a challenge for forecasters. I think it is a challenge for all of us in Government, in the executive branch and the legislative branch, in thinking about policies.

It is important, I think, to start out with the long term. One thing that is very clear about the American economy is that productivity growth is not only good for us absolutely; that is, we have had an increase in structural productivity growth in the United States, but it is good relative to our trading partners, and most of that is not because of what we do here in Washington, it is because of the strength and resiliency of the private sector in the United States and institutions that promote that flexibility, and part of our role is to try to think of policies that bolster that flexibility.

In the short term, as I said, we experienced a recession that is atypical by post-war standards, in particular, because of the key role played by business investment. As we have argued in the Administration, and I think the President has said very persuasively, a key downside risk in the economy at the moment also comes from investment. Public policy, as you know, has been quite active. The Federal Reserve has worked very, very hard for an accommodative monetary policy. In the Executive and legislative branches, of course, fiscal policy has been quite appropriately propping up the economy's near-term prospects.

In terms of risks to the outlook, the key risk that we see in the Administration is a delayed investment recovery. Built into most of the forecasts in the private sector is a very timely and vigorous investment recovery. As I talk with business executives around the country, as I am sure all of you do, one gets a sense of delay, a sense of very high hurdle rates or a bar over which new investments must jump. Part of this reflects general uncertainty in the environment, partly it reflects concerns over corporate governance.

At the same time, in the consumer sector, there is a possibility, given the significant loss of wealth in the household sector, that consumers might engage in a bit of what economists call some precautionary saving in response to changes in uncertainty.

The President, as you know, put out a very bold jobs and growth initiative. You know, of course, what is in it. What I would like to do is explain why we think the President's initiative is aimed foursquare at the problem.

First of all, the most immediate effect I think from the President's plan in addressing the investment issue comes from the reduction of cost of capital for many small businesses who are, one, paying taxes at individual rates, and of course the rate cuts are accelerated, and from a dramatic increase in small business expensing.

In addition, eliminating the double tax of corporate income, both on the dividend side and retained earnings side, is a significant pro-investment change in the tax code. We have estimated at the Council that the cost of capital for investment would fall by between 10 and 25 percent, depending on the assumptions you use about the life of a piece of equipment or how that equipment is financed.

To those who say there is no short-term effect, let me translate that into something that is more familiar in our policy discussions, which is an investment tax credit. What the President proposed in eliminating the double tax would be the equivalent of between a 4- to 7-percent investment tax credit. Put that way, I think you can see this is a very large change in investment policy, not simply aimed at long-term growth.

We believe that eliminating the double tax also has very important effects on corporate governance by making debt and equity on a more neutral footing, taking a lot of the wind from the sails of financial engineering and increasing the premium on cash and transparency and decreasing the premium on the management of earnings.

The President's proposals would also help, we believe, shore up the problem that is identified on the consumption side. This comes from the acceleration of the tax relief already in place. That is, of course, principally accelerating marginal rates, but also the child tax credit and marriage penalty relief.

The cash out the door, if you will, from the Treasury, is estimated by our Treasury to be about $52 billion in calendar year 2003. That could be bigger, depending on the timing of changes. This is, of course, the down payment on a long-term tax cut, and economists have long believed the responses of consumers and businesses to long-term tax changes substantially exceeds that through short-term changes. So not only is the cash out the door, in terms of what the President is proposing, as large or larger than many of the alternative plans that have been surfaced, but also, by being long term, is likely to have a much bigger effect. To be concrete, for a family, a typical family of four, with the two earners making ($39,000) would get $1,100 in relief in the President's plan.

We believe also the plan has very important effects on the employment market in the United States, most directly by raising GDP growth, but also through the proposal for reemployment accounts, which is a very bold and new way of trying to get people back to work, instead of simply languishing on unemployment insurance.

I think it is important, as I mentioned at the beginning, to note how the proposals will help the economy in the long run, and here there is a lot of confusion as to who actually bears the burden of a tax. Sometimes we think who bears the burden of a tax is who writes the check to the IRS. So, for example, if we are thinking about the proposal to eliminate the double tax on corporate income, is this about people who get dividends and retained earnings capital gains? Of course, in part, it is.

Economists argue that most of the burden of the double tax is not borne by those people, it is borne by all of us. To see why, we know intuitively when we double tax something, we get less of it, and here the something we are getting less of is capital formation. As we get lower capital formation, we get a lower level of productivity and lower wages. Who bears this tax in a dynamic economy like ours is all of us, in terms of our wages, not the recipients of dividends for capital gains.

A very important question, of course, for the short term and the long term, is the effect of the policy on the fiscal position of the Government. We, in the Administration, like all of you, are very concerned about the country's fiscal outlook. We do not believe that tax relief of the kind and size that the President proposes worsens substantially the Government's fiscal position.

The way I think of this, as an economist, is to look for a fiscal anchor, and the most logical fiscal anchor is thinking about our debt-to-GDP ratio, which does not rise in response to the President's proposals. The comment on deficits and interest rates that is often mentioned is one where, as a profession, we believe we know the sign, and I am delighted to note that the Senator purchased my textbook. I hope he purchased it, so I can get some royalties for my kids. [Laughter.]

Mr. HUBBARD. I think we know the sign. The magnitude depends a lot on the types of deficits and what they are used for. Just as a household or a business, it matters what you do with the money, so it does for Government. We believe that pro-growth tax policies are very much in our country's interest and very much have a high internal rate of return.

Is the notion of deficit welcome? No. Is it understandable? Yes, for much of the reasons that Senator Nickles made in his opening presentation. We, in the Administration, the Congressional Budget Office and many in the private sector missed the mark on forecasts of surpluses in recent years. There is no doubt about it. Much of that has to come with complex changes in our economy that I look forward to discussing with you, if you like.

Let me end by closing on the economics of the President's plan. We believe that this plan adds substantially to GDP growth. If you look at the changes in the cumulative level of GDP going forward, about nine-tenths of a percentage point in the end of the first calendar year, and about 1.8 percent by the end of 2005. These level effects of GDP are persistent. They are largely permanent, which means two things; one, a larger economy and, second, a larger feedback for Federal revenue.

Thank you very much, Mr. Chairman.

[The prepared statement of R. Glenn Hubbard follows.]

Testimony
of
R. Glenn Hubbard
Chairman, Council of Economic Advisers

before the
Budget Committee
United States Senate

Tuesday, February 4, 2003
2:30 p.m.

Chairman Nickles, Ranking Member Conrad, and members of the Committee, I thank you for the opportunity to discuss how the President's Jobs and Growth Initiative will affect the economy. The central role of the package is to support near-term economic growth at the same time it improves the long-run productivity of the economy. This approach to fiscal policy is appropriate in the short run, because it focuses on what the economy needs now—faster investment and higher job growth for today's workers. But just as important is the effect that the President's package will have on the overall productivity of the economy. Higher taxes on corporate capital act to reduce investment, which in turns lowers the amount of capital that workers can use at their jobs. With less capital, workers are less productive, so they are paid less. By ending the double tax on corporate income and permanently raising expensing limits for small firms, the President's package encourages investment. This starts the virtuous circle of higher investment and job growth today, with higher capital stocks, productivity, wages, and standards of living tomorrow. In the end, the more productive economy will be better able to support the large number of workers who will soon retire.

Any discussion of how the proposal will affect the economy must discuss how it affects the government's fiscal position. One of the most important lessons of the past several years is the importance of strong economic growth for the Federal government's fiscal health. Accordingly, the central role for fiscal policy is to craft a tax policy that reduces tax-based distortions that hinder growth, while at the same time limiting the growth of government outlays to a sustainable path. Given the importance of economic growth to the government's fiscal position, I will start my testimony today by reviewing the economic situation currently facing our Nation. I will then discuss the ways in which the President's proposals contribute to higher growth, specifically by targeting business spending on investment.

At the start, however, I would like to stress an important fact: While the past two years have presented many challenges to the American economy – the long decline in the stock market and the terrorist attacks and economic contraction in 2001 – our long-run economic outlook is as strong as it has been in a generation. As Chart 1 shows, the trend rate of U.S. labor productivity growth has risen from rate of 1.4 percent per year from 1973 to 1995 to 2.5 percent per year from 1995 to 2000. Because higher productivity growth is the foundation of higher incomes and living standards, the productivity acceleration is good news for all of us. What is more, over the last four quarters for which we have data, labor productivity has risen by 5.6 percent – the best four-quarter change in productivity since the early 1970s. The ongoing productivity revival speaks well for the long-term outlook. Additionally, inflation remains low and stable, which helps the economy interpret relative price signals efficiently and which gives policymakers the room to support near-term growth.

THE ECONOMIC SITUATION IN 2002

In many ways, the economy's recent performance has been different than that of past recoveries since World War II. Typically, business investment declines most sharply in recessions and expands most briskly in recoveries. By contrast, the household and government sectors do not fluctuate as much. In 2002, however, the recovery from the economic contraction of the previous year took place amid continued weakness in business investment and strength in the household sector. After rising at an annual rate of 3.4 percent during the first three quarters, GDP rose at an annual rate of 0.7 percent in the fourth quarter. Business fixed investment rose at an annual rate of 1.5 percent in the fourth quarter – the first quarterly increase since mid-2000 – but much larger rates of increase will be needed for the recovery to be fully established.

Household sector. In large part, the strength of the household sector last year stemmed from the aggressive monetary easing by the Federal Reserve in 2001. Over the course of that year, the Federal Reserve cut its target federal funds rate eleven times, lowering the target from 6.5 percent to 1.75 percent. Given the well-known lags in monetary policy, these reductions continued to provide stimulus throughout 2002. Lower interest rates, for example, allowed motor vehicle companies to offer aggressive financing incentives, which have supported auto sales through much of the year.

Additionally, the substantial cuts in the target federal funds rate by the Federal Reserve have translated into lower mortgage interest rates, supporting housing starts and mortgage refinancing. In the first three quarters of 2002, mortgage refinancing alone injected more than $100 billion into home owners' pocketbooks. After they paid down second mortgages and outstanding home equity loans, they had more than $59 billion left over to spend in other ways. Survey evidence indicates that about half of this $59 billion was probably used for consumption and home improvements – two components of aggregate demand – which would have raised nominal GDP by about 0.4 percent in the first three quarters of 2002. All in all, the interest rates cuts were helpful in maintaining the recovery last year. The most recent rate reduction of 50 basis points undertaken on November 6, 2002, will provide further support for the recovery in 2003.

Fiscal policy has also been an important force behind robust consumption in 2002. In addition to enhancing long-term economic efficiency, the tax cut proposed by the President and passed by Congress in 2001 provided valuable support for disposable income, which has been far more robust than is typical at this stage of a recovery. The upshot has been solid growth in both personal consumption expenditures and residential investment that has supported the recovery so far.

Business investment. In contrast to positive impetus from the household sector, business investment has been the economy's key weak spot. As I noted earlier, during the current business cycle, the decline in business investment has been sharper, and the recovery more modest, than an average postwar business cycle. On average, the peak-to-trough decline in nonresidential investment in the typical post-war recession is 6.2 percent. Assuming that the trough in the most recent recession occurred during the fourth quarter of 2001 – a decision that ultimately resides with the National Bureau of Economic Research – the corresponding decline in the most recent recession was 8 percent. Comparing the typical pace of recovery, during the first four quarters of this recovery, business investment fell 1.9 percent further, compared to a typical increase of roughly 5.3 percent four quarters into a recovery. Chart 2 displays the current weakness investment graphically, by comparing it to the typical experience of recoveries since 1960.

Simply put, the recovery in investment that one would expect at this stage of the business cycle has yet to materialize.

The current weakness in investment results is linked to adverse developments in equity markets during the past three years. Indeed, both stem in large part from the same underlying shock – a scaling back of expected profit growth. Evidence that earnings growth was adjusted downward comes from surveys of Wall Street analysts who track individual firms. According to one such survey, five-year-ahead earnings growth forecasts for the firms in the S&P 500 fell from a peak of more than 18 percent per year in mid-2000 to slightly more than 13 percent per year by September 2002. Another factor in lowering both equity values and business investment is the current risk climate. Higher levels of uncertainty in the economy and/or higher aversion to risk on the part of investors reduce the willingness of investors to hold corporate equities and lowers stock prices and investment. One reflection of the risk outlook is the spread between yields on corporate bonds and U.S. Treasury securities, because corporate bonds are subject to default risk while U.S. Treasury securities are not. The widening gap between yields for corporate and Treasury securities after 2000 coincided closely with the decline in the stock market during this period. Corporate-Treasury spreads continued to widen sharply in 2002, reaching near-record levels, indicating that risk aversion played a key role in markets in the months following September 11, 2001 as well.

Inventory investment contributed strongly to the economic slowdown in 2001, but by early in 2002, the pace of inventory decline slowed, providing a significant boost to production. In some sectors of the economy, evidence suggests that inventory restocking is underway. Over the next several quarters, as inventory and sales growth come together, inventory investment should provide upward momentum to the recovery.

Government purchases. The war on terror continued to exert upward pressure on Federal government purchases in 2002. In late March, for example, the President requested that Congress provide an additional appropriation of $27.1 billion, primarily to fund the effort in the war against terror. More than half of this amount was allocated to the activities of the Defense Department and various intelligence agencies. Most of the rest was needed for homeland security (mainly for the new Transportation Security Administration) and for the emergency response and recovery efforts in New York City. Though most of this spending was required for one-time outlays, it nevertheless contributed to the large 7.3 percent annual rate of increase in real Federal government purchases in 2002. State and local government purchases rose by a more moderate 1.7 percent annual rate during the same period.

External sector. While the United States economy remained below potential in 2002, its growth rate still outpaced that of many other industrialized countries. Growth in Canada – America's largest trading partner – was a healthy 4.0 percent in during the four quarters ending in the third quarter of 2002, but growth in many other countries, including Mexico, France, Japan, and Italy lagged behind. Low demand for U.S. exports combined with the emerging recovery in the United States (and the consequent increase in U.S. demand for imports) caused the U.S. trade deficit to reach record levels in 2002.

The widening trade deficit placed additional downward pressure on the U.S. current account balance, which reached a deficit of almost five percent of GDP in the middle of 2002. As a matter of accounting, the current account balance is simply the difference between net domestic investment and net domestic saving. Several factors can raise the current account deficit, including higher investment within our borders on the part of foreign investors, or lower savings rates on the part of U.S. citizens. In light of the large number of trade-related and financial forces operating on the current account, it is impossible to label a current account deficit as either "good" or "bad." Indeed, one factor contributing to high U.S. investment relative to savings is the rapid increase in U.S. productivity relative to many other major countries, which makes the United States a good place to invest. Because productivity growth is ultimately responsible for rising living standards, the current account deficit reflects at least in part good news about the American economy. Even so, a current account deficit indicates that the United States is consuming and investing more than it is producing, and the U.S. current account has typically been in deficit for the past two decades. As a result, the net international investment position in the United States has moved from an accumulated surplus of slightly less than 10 percent of GDP in the late 1970s to a deficit of almost 20 percent of GDP in 2001.

Recent increases in the current account deficit have led to some concerns that continued current account deficits (and the subsequent increases in international debt that would result) could not be sustained. Because debt has to be serviced by the repatriation of capital income abroad, the ratio of a country's debt to its income must stabilize at some point. Yet the United States is currently far from the point at which servicing our international debt becomes burdensome. In fact, until 2002, more investment income was generated by U.S. investment in foreign countries than was generated by foreign investments inside the United States.

In the end, the key determinant of the sustainability of the U.S. international debt position is continued confidence in the economic policies of the United States. As long as the United States pursues its current market-oriented, pro-growth policies, then the current account deficit will not represent an impediment to continued economic growth.

Labor market. The unemployment rate hovered between 5.5 and 6.0 percent throughout 2002 after rising 1.8 percentage points in 2001. Nonfarm payroll employment in 2002 was similarly weak, with 181,000 jobs lost in 2002, compared with 1.4 million jobs lost the previous year.

As in past business cycles, declines in manufacturing employment have been especially pronounced. Factory employment fell nearly 600,000 in 2002, following a decline of 1.3 million in 2001 and about 100,000 in 2000. Another feature of previous business cycles that has recurred in the past two years is the increase in the number of workers who report a long unemployment spell. Like the overall unemployment rate, the number of workers unemployed for 27 weeks or more rose in the 2001 and 2002. Yet the pattern of long-term unemployment observed in 2001 and 2002 was similar to patterns traced out in previous postwar fluctuations. Like the overall unemployment rate, the level of long-term unemployment remains moderate relative to past business cycles.

RISKS TO THE OUTLOOK

The slowing of GDP growth and weakness in labor markets in the fourth quarter of 2002 highlight the risks the recovery currently faces. In order of importance, these risks include:

A Delayed Investment Recovery. The key to transforming the current recovery into sustained robust growth is an increase in the pace of business fixed investment. Only with robust business investment will labor markets improve. A recovery in investment is a key factor in creating more jobs—when companies build new factories, they hire new workers and boost employment in capital-goods industries.

While private forecasters expect business investment spending to recover in 2003, there are several potential sources of a delay in an investment recovery. One risk is weaker profit growth. Due to a sharp increase in the fourth quarter of 2001, corporate profits have rebounded from recessionary lows. Yet the recovery in profits has been uneven. In the first three quarters of 2002, profits as a share of income averaged 7.5 percent. While this represents a recovery from the 7.2 percent share in 2001, it is still below shares of 8.7 percent in 1999 and 7.9 percent in 2000. Moreover, on a quarterly basis, corporate profits declined in each of the first three quarters of 2002. Because current profits are an indicator of future profits, firms may interpret recent weakness in profit growth as an indication of reduced investment opportunities. The decline in profits may have an even more negative impact on investment at firms that depend on retained earnings (rather than external capital markets) to fund investment projects.

A second potential setback to the investment recovery reflects an increase in the level of uncertainty about the course of the near term events or higher levels of risk aversion on the part of investors. Higher levels of uncertainty in the economy can also make firms delay new projects until the uncertainty is resolved. This delay is translated into a higher expected rate of return in order for new projects to be undertaken, which reduces the level of investment that is undertaken in the near term. Additionally, higher levels of risk aversion on the part of investors can reduce investment by making it harder for firms to raise external funds.

A Decline in Consumer Spending. As mentioned, the recent business cycle stands apart from the typical postwar recession in that household income growth has been stable while stock price declines have eroded household wealth. In the typical recession, incomes and net worth move together, but in the most recent recession, net worth fell dramatically relative to income. Yet in contrast to the negative effect of lower equity values on business investment, consumption has remained remarkably robust, even as household net worth has suffered. The contrast in the pattern of spending mirrors a reversal of conventional income and wealth dynamics. In the current cycle personal income – especially disposable personal income, supported by the tax cuts of 2001 – has held up quite well, even as household balance sheet positions have weakened.

The deterioration in household wealth over the past three years raises the possibility that consumers will increase their active saving out of disposable income in order to restore at least some of their lost wealth. An increase in precautionary saving of this type could have a substantial effect on yearly consumption. From the first quarter of 2000 to the last quarter of 2002, households lost nearly $7 trillion in equity wealth. A rough rule of thumb suggested by aggregate data on wealth and consumption is that yearly consumption declines by 3 to 5 cents for every dollar of lost equity wealth. Based on the midpoint of this range, the $7 trillion reduction in equity wealth since early 2000 would be expected to eventually lower yearly consumption by about \$280 billion per year. For comparison, a reduction of this amount would represent nearly 4 percent of consumption and almost 3 percent of GDP in 2002.

Empirical findings also suggest that the response of consumption to changes in stock market wealth is drawn out over time, which has crucial implications for the precise path of consumption over the next few years. Because the appreciation of equity prices before 2000 would be expected to increase consumption, some of the implied \$280 billion drop in consumption after 2000 may simply represent a "cancellation" of an implied consumption increase that had not yet taken place. Moreover, positive influences from the other determinants of consumption (such as current income and the continuing appreciation in housing wealth) are likely to offset the stock market's negative effects on personal spending. Even so, the possibility that consumers might pull back somewhat represents a risk to the recovery in the near term.

An Increase in Oil Prices. Oil prices trended upward in 2002, with the spot price of the benchmark West Texas Intermediate rising from about \$20 per barrel at the start of the year to about \$32 by year's end. Much of the increase was due to the recent turmoil in Venezuela. The general strike in that country began in the first week of December; since then, the WTI price has risen from around \$27 dollars per barrel to about \$33 dollars per barrel today. Concerns over the failure of the Iraqi regime to disarm in a credible way may have also been partly responsible for the increase in oil prices in 2002.

The effect of further oil price increases on the economy is difficult to determine. To be sure, there are "rules of thumb" that are often used to quantify the effect of export disruption on oil prices as well as the subsequent effect of higher oil prices on GDP. For disturbances of a few million barrels per day, a reduction of oil supplies of one million barrels per day typically raises prices by about 3 to 5 dollars per barrel. Additionally, a sustained increase in oil prices of \$10 per barrel would be expected to lower GDP growth by about 0.25 to 0.50 percentage points after six months to one year. While these rules of thumb are useful guideposts, the actual effect to the economy could vary greatly from episode to episode. For example, a disruption of oil production that was that was expected to last indefinitely would affect prices differently from one that was likely to be unwound quickly. Moreover, if higher oil prices accompany a serious deterioration in consumer and business confidence, the ultimate effect on GDP could be much larger than a simple rule of thumb would suggest.

THE PRESIDENT'S JOBS AND GROWTH INITIATIVE

In light of the risks to the near-term outlook, the President has advanced a proposal to enhance long-term growth while providing near-term support against downside risks to the Nation's economic outlook. It is important to note that the recovery is not in immediate jeopardy. Private forecasters expect the recovery to gather momentum over the coming year, with both higher investment and improved job growth. Yet the presence of current risks suggests that insurance against unforeseen deterioration in economic activity is especially valuable. The best proposals are those that will raise the rate of long-term growth even if the recovery takes shape as private forecasters anticipate.

The President's proposal targets the areas that are most fundamental to the continued health of the current recovery – investment, consumption, and job growth. Specifically, the proposal will:

1. Accelerate to January 1, 2003 features of the 2001 tax cut currently scheduled to be phased-in: the reductions in marginal income tax rates, additional marriage penalty relief, a larger child credit, and a wider 10 percent income tax bracket.
2. Eliminate the double taxation of corporate income, whether this income is paid out to individuals as dividends or retained by the firm. Dividend income will no longer be taxable on the individual level, while a step-up in basis will be allowed in order to reflect the effect of retained earnings on share prices.
3. Increase to $75,000 the amount that small businesses may deduct from taxable income in the year that investment takes place.
4. Provide $3.6 billion of funds to the states to fund Personal Reemployment Accounts. These accounts provide up to $3,000 to assist unemployed workers who are likely to need help in finding or training for a new job. If a new job is found quickly, the unspent balance in the account can be kept as a "reemployment bonus."

How the Proposals Will Help the Economy in the Near Term

Supporting investment. To be effective in aiding the current recovery, any proposal must support investment. The President's proposals do this in three ways: ending the double taxation of corporate income, raising the expensing limits for small businesses, and lowering individual marginal tax rates (which are the relevant tax rates for small businesses that pass through their income to their owners).

The most immediate effect of ending the double taxation of corporate income will be to lower the cost of capital faced by firms in equity markets. Under the double taxation inherent in the current law, investment projects funded with new equity capital face effective rates of federal taxation of up to 60 percent. The President's proposals address this problem by removing the layer of tax at the individual level. Corporate income will be taxed once – and only once – which will make corporate equities more attractive to investors and lower the implicit cost that firms pay for equity-financed investment. As an example, the cost of capital for equity-financed equipment investment in the corporate sector would fall by more than 10 percent. For investment in structures – the weakest part of the investment outlook today – the decline in the cost of corporate equity capital would be more than one-third. For equipment investment, this decline in the cost of capital is equivalent to an investment tax credit of four to seven percent.

In addition to the direct stimulative effects of lower costs of equity capital, ending the double taxation of corporate income will rationalize dividend payout policy among American companies. This will aid investment, even in the short run. Currently, the tax code encourages firms to retain earnings and remit income to shareholders through share repurchases. This gives firms an incentive to inflate their reported earnings, so that their stock prices will rise. A main goal of the President's policy is to reduce this incentive by making tax policy neutral with respect to retaining earnings or paying dividends. Firms wanting to transmit their profitability to outside investors need only show them the money, in the form of dividend checks. With less uncertainty about the true profitability of firms, investment funds will flow more easily to firms with good investment prospects. This will not only make financial markets more efficient, but—like the reduction in the equity cost of capital—may also raise the total level of investment.

Other parts of the proposal support investment for smaller firms. Small firms will be allowed to expense up to $75,000 in new investment, which will lower the tax-adjusted cost of capital significantly. Eligibility for this immediate deduction would begin to phase out for small businesses with investment in excess of $325,000, which is increased from $200,000. (Both the expensing limit and the phase-out range will be indexed to inflation.) Additionally, the acceleration of the marginal tax rate reductions will help firms that pass through earnings to their owners. According to the Treasury Department, more than 30 million individual returns listed small business income in 2000. Virtually all of these firms will enjoy marginal tax relief by accelerating the rate reductions which have already been approved by Congress.

Supporting consumption. Consumption accounts for about two-thirds of economic activity, and consumption spending must remain vigorous if the recovery is going to continue. The President's proposals will accelerate the tax relief that has already been enacted, which will put more money in the pockets of consumers this year -- when it is needed most. The Treasury estimates that calendar-year tax liabilities will be reduced by almost $100 billion in 2003. Of this amount, about $29 billion will be due to the marginal rate reductions, while another $16 billion will result from the acceleration of the increase in the child credit. On a "cash-out-the-door" basis, the proposal as a whole will infuse around $52 billion into the economy this year, and tax savings for individual families will be substantial. A typical family of four with two earners making a combined $39,000 in income will receive a total of $1,100 in tax relief under the President's plan.

As with any attempt to increase economic activity with a tax cut, an important question is how much of the cut will actually be spent. An acceleration of the marginal tax reductions in the 2001 tax cut is likely to result in significant spending increases, because the acceleration is done in the context of long-term tax relief. Delivering tax relief now, rather than in 2004 and 2006, sends a message that the government will meet its commitment to the American people to allow them to keep more of what they earn. As taxpayers realize that their long-term disposable income has risen, their spending plans will rise as well. By contrast, tax policy based on temporary changes to tax rates, or one-time tax rebates, has rarely worked as advertised. A temporary tax increase did not rein in the economy in 1968, a temporary tax cut did not stimulate the economy in 1975, and a temporary tax cut is not the right policy for 2003. Former Federal Reserve governor and CEA member Alan Blinder has written that in the year after enactment, a temporary tax cut has at most only about half the effect of a permanent tax cut.

Supporting job growth. The best policies for improved job growth are those that insure the economy itself will continue to grow. Still, government policy can affect the rate at which unemployed workers find and train for the jobs that a growing economy provides. The Reemployment Accounts in the President's proposal build on the existing Workforce

Development System and empower unemployed workers by giving them more flexibility and personal choice over their assistance. Unemployed workers have a wide range of needs and are best-suited to understand their particular circumstances. Some workers may want extensive retraining. Others may not require retraining, but may need help relocating or with childcare while looking for work. Economists have long recognized that except in rare circumstances, giving individuals choices over how to spend their money improves their welfare. In this case, giving unemployed workers a choice of whether to receive training or to receive other services for which they may have a greater need will not only improve the efficiency of government services (by matching unemployed workers with the services they need most), it will improve unemployed workers' welfare at the same time.

The potential to receive a reemployment bonus would provide eligible workers a greater incentive to find new employment. At various times from 1984 to 1989, four states—Illinois, New Jersey, Pennsylvania, and Washington—conducted controlled experiments to determine the effectiveness of providing reemployment bonuses to unemployed workers. In these experiments, a random sample of new UI claimants were told they would receive a cash bonus if they became reemployed quickly. The advantage of these experiments is that the effect of offering a reemployment bonus on the duration of unemployment and on earnings upon reemployment can be directly evaluated by comparing the experiences of UI claimants randomly chosen to be offered a reemployment bonus with those of UI claimants not chosen for the bonus (who received the regular state UI benefit).

An evaluation by the Department of Labor of the reemployment bonus experiments conducted in the states of Washington, New Jersey, and Pennsylvania showed that a reemployment bonus of $300 to $1,000 motivated the recipients to become reemployed, reduced the duration of UI by almost a week, and resulted in new jobs comparable in earnings to those obtained by workers who were not eligible for the bonus and remained unemployed longer. Similarly, a study of the experiment conducted in Illinois—and published in a leading American economics journal—found that a reemployment bonus of $500 reduced the duration of unemployment by more than a week and did not lead to lower earnings at the worker's next job. This evidence suggests that giving unemployed workers the option of receiving the unspent balance in their Personal Reemployment Accounts will provide an incentive to find a new job quickly, reducing the time spent unemployed, but will not result in workers taking lower paying jobs than they would get if they searched longer.

Total effect on the economy. As chart 3 shows, CEA estimates that the package would raise the level of real GDP at the end of 2003 by 0.9 percent above the level it would have been absent the proposal. At the end of 2004, the level of real GDP would be 1.7 percent higher than it would have been without the proposal, and 1.8 percent higher than otherwise at the end of 2005. Put in terms of GDP growth rates measured from the fourth-quarter of 2002 to the fourth-quarter of 2003 and so on, the package will deliver an additional 1.0 percentage points of higher growth in 2003 than would have been the case otherwise, and an additional 0.8 percentage points of higher GDP growth in 2004. This increase in GDP will immediately put more Americans back to work, delivering about 510,000 jobs in the second half of 2003 alone. The plan will create another 891,000 new jobs in 2004. The plan works so well because it is focused on what the economy needs now—it encourages an investment rebound while supporting continuing growth in consumption.

How the Proposals Will Help the Economy in the Long Run

In the near term, the President's proposal insures that the recovery proceeds by supporting investment. In the long run, the higher investment delivered by the plan leads to higher productivity – the fundamental source of higher standards of living for American workers. Economists have long known that from the workers' point of view, the best level of capital taxation is no taxation at all. The reason for this surprising result concerns the burden, or "incidence," of the capital tax. An investor with an extra dollar to spend can either use it to fund consumption today or save it to fund a larger amount of consumption later. His or her preferences for consuming now versus consuming later determine how much extra consumption he or she must enjoy in the future in order to resist consuming the dollar's worth of goods and services today. Lowering the capital tax means that investors receive larger after-tax returns on their investments. This change in returns makes it more likely that households will defer consumption and instead invest, which will raise the amount of savings available to firms that want to borrow in financial markets. As firms invest more, the amount of capital available to workers goes up, as does their productivity. In the end, higher productivity raises workers' wages and standards of living. This line of reasoning shows that even though workers may not write a check to the IRS for dividend taxes, all of us as workers still pay part of the double tax on corporate income such as dividends in the form of lower wages, because the tax reduces the amount of capital in the economy.

Workers enjoy long-run gains from the President's proposals in other ways as well. Marginal rate reductions and permanently higher expensing limits for small business will raise investment, which in turn raises productivity and wages for the same reasons outlined above. The rationalization of dividend payout policy will improve corporate governance and place corporations on equal footing with non-corporate users of capital. Both of these developments will improve the efficiency of markets. (A 1992 Treasury Department report on the double taxation of corporate equity showed that the reallocation of capital toward more efficient uses would raise economic well-being in every year in the future by the equivalent of $36 billion worth of consumption in today's dollars.) Additionally, ending the double tax in the way in which the President has suggested will increase economic efficiency by reducing the incentives for corporations to engage in tax sheltering activities, because only income on which corporate taxes have been paid can be transmitted to shareholders tax free.

The Effect of the Proposals on National Saving and Budget Balance

Some critics of tax relief have argued that now is not the time to cut taxes, but to raise them. The view is that if the government adopts deficit reduction as its number one goal, growth will somehow follow. I disagree. To begin with, surpluses tend to follow growth, not the other way around. Raising taxes may lower the deficit, but this is not equivalent to spending restraint that limits the size of government in the economy and lets the private sector create jobs. Standard models of the economy suggest that an increase in debt of $200 billion dollars would raise long-term interest rates by 3 to 5 basis points. This modest increase in interest rates must be set against the large costs that a current tax increase would entail – higher distortions on saving, risk-taking, and entrepreneurship, as well as the loss of credibility that comes when the government reneges on its promise to provide Americans with tax relief.

In addition, the tax relief the President suggested in his January proposal does not significantly worsen the government's fiscal position. One way to judge the effect of tax proposals on the government's fiscal position is to view them in the context of a "fiscal anchor," such as the debt-to-GDP ratio, or the share of federal outlays that go to service the government's debt. Even with the President's proposal, the debt-to-GDP ratio does not rise in the out-years of the budget window. Moreover, the effect on the proposal on debt service costs is small. According to either of these potential fiscal anchors, the tax relief offered in the President's proposals remains sound policy.

CONCLUSION

Though the long-term fundamentals for the U.S. economy are strong, we still face a number of challenges. The recovery which began in the fourth quarter of 2001 must be maintained, and fiscal policy must remain on sound foundation. By focusing on the economy's most uncertain component – business investment – the President's proposals insure that the recovery will proceed. Although the proposals focus on the economy's near-term needs, they also promote stronger growth in the long term as well. In doing so, they insure that the standard of living enjoyed by American workers will continue to improve in the coming years.

Chart 1: Labor Productivity (Nonfarm Business Sector)

Index, 1992 = 100 (ratio scale)

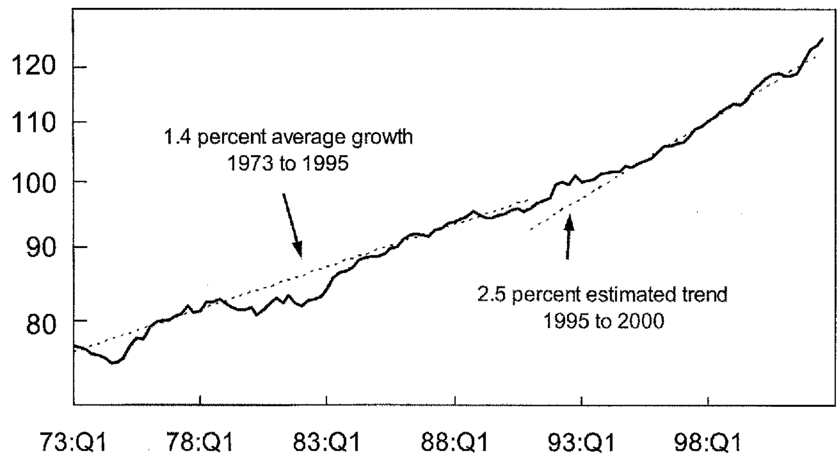


Chart 2: Real Nonresidential Fixed Investment

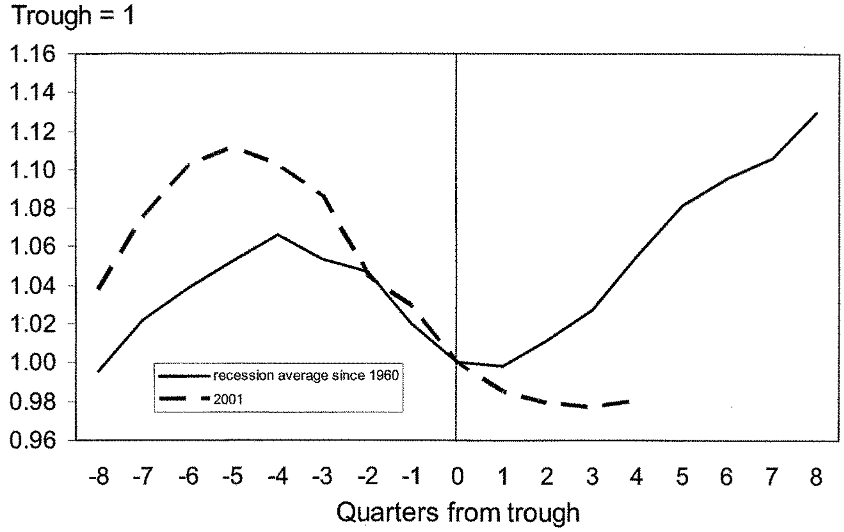
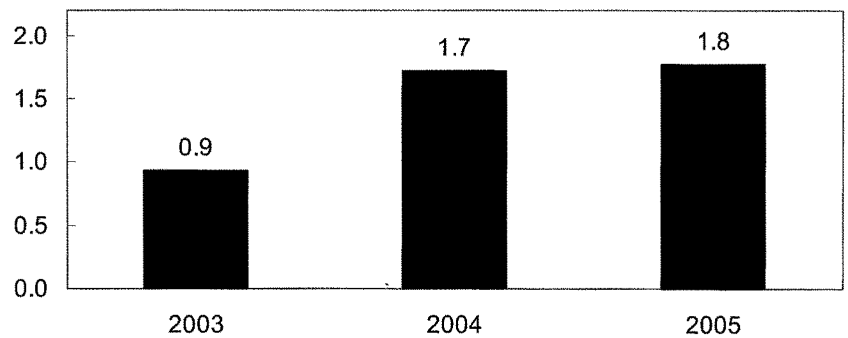


Chart 3: Growth Package Effect on Real GDP

Percentage difference of the level of real GDP at the end of the fourth quarter from the level without the President's proposal.



Fourth-quarter to fourth-quarter growth rates are higher by 1.0, 0.8 and 0.0 percentage points for 2003, 2004 and 2005, respectively.

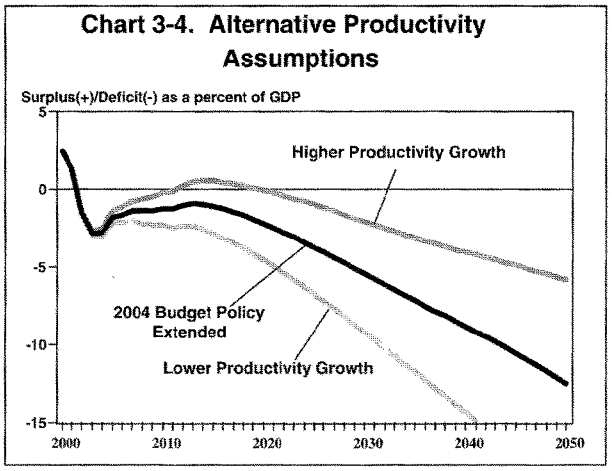


Chart 3-4. Alternative Productivity Assumptions
Surplus(+)/Deficit(-) as a percent of GDP
Higher Productivity Growth
2004 Budget Policy Extended
Lower Productivity Growth
5
0
-5
-10
-15
2000
2010
2020
2030
2040
2050

Chairman NICKLES. Dr. Hubbard, thank you very much.

I am glad that Senator Corzine joined us as well, so thank you for coming.

Let me just ask you a couple of questions. You mentioned, under your proposal, your effort to eliminate double taxation of dividends, and a little birdie tells me that you were very instrumental in getting that included in the President's proposal, so I will compliment you on it.

I think many people, and almost all economists, I would believe, would think that double taxation is not good tax policy. It needs to be fixed. Some might argue maybe not now or maybe it should be done in the form of more comprehensive tax reform, but it is not good tax policy to tax such a large percentage of distribution of corporate earnings. The tax rate I believe I saw in the handout last week is 60 or 70 percent; is that correct?

Mr. HUBBARD. That is correct.

Chairman NICKLES. A corporation pays 35 percent, an individual, whatever their collective rate is. It might be 28, it might be higher, it might be lower. Is there an effective rate that you count or can estimate that corporate dividends are taxed at in the United States compared to other countries? I saw one chart that had us listed as the second-highest tax rate on dividends of all industrialized countries; is that correct?

Mr. HUBBARD. That is correct. For new equity finances, money just going into the corporate sector, only Japan, among major countries, would have a higher tax rate. This is because I think most of the industrial world has some kind of dividend relief, not always complete, but some sort of dividend relief. We really are the outlier in that respect.

Chairman NICKLES. I have often thought it was wrong, and I may have some bias because I used to run a corporation, but I thought the best way to fix it would be to allow the corporations to deduct dividends, just like they deduct interest. They write a check for dividends, why can they not expense that with before-tax dollars instead of—or just get an expense for dividends, just like they get an expense for interest. Is that not another way of doing it?

Mr. HUBBARD. Well, if everybody in the economy faced the same tax rates or the corporate rate is the same as individual rates, there is no tax-exempt entities, from a purely economic perspective, you could give relief at the individual level or the corporate level. It would be the same effect on the cost of capital.

What the President was trying to do, and has said many times, is make sure that income is taxed once, and only once, and he means the "once" part, as well as the "only once" part. If you do relief at the corporate level, given the importance of exempt shareholders and foreign shareholders, it is quite possible much of the income is not taxed at all.

A second reason we had was, in terms of thinking about corporate governance, relief at the individual level puts a great deal of pressure on management to meet the judgment of the capital markets. If they have good projects, of course, they can retain earnings, but there is the constant pressure from the capital market.

So you are right, relieving double tax on either margin is in the economy's interest. Those are the principal reasons the President used in his decision.

Chairman NICKLES. I was assuming one of the reasons was that it might cost a lot more because you do have a lot of dividends that are in tax-exempt status, 401(k)'s, retirement accounts and so on.

Mr. HUBBARD. It clearly costs more, but I think his concern was principally with the argument that we want to tax it once, and only once.

Chairman NICKLES. Let me ask you a question. There is also a very significant retirement savings or both savings and retirement savings proposals by the Administration. I do not believe you alluded to those too much, but those would have the impact of basically creating what I would call a Roth IRA, but basically after-tax dollars going into an account that would have tax benefits of not paying taxes on accumulated earnings; is that correct?

Mr. HUBBARD. That is correct, Senator.

Chairman NICKLES. Do you want to further explain how that would also help the economy.

Mr. HUBBARD. Sure. First of all, one big reason for the Lifetime Saving Account and Retirement Saving Account proposal, to which you are alluding, is simplification. Under current laws, you know many families have access to a bewildering array of savings incentives with different phase-outs and different rules, and it seems quite silly to tell people you should save for this, that and the other purpose, as opposed to giving them choice and control.

What the President's proposal would do is create one nonretirement and one retirement vehicle. By expanding contribution limits, this would significantly increase savings. There is a large body of work in economics. I confess I have contributed to it, so I have a bias in my statement, but I believe these plans have significant chances to increase saving.

A counterargument that you often hear is, well, this is just reshuffling, and to that, I would ask you the question how many American families do you think, on a year-to-year basis, can reshuffle $7,500 in cash for every member of their family? Not many.

Quite quickly, this is marginal saving, new saving for the economy.

Chairman NICKLES. So the proposal on the lifetime savings, I thought was $7,500 per person, and so I was assuming that would be $15,000 per couple.

Mr. HUBBARD. That is correct. That is my point, that if your argument is you are not getting any new saving for people who are really saving at those rates, that is largely going to be new saving. Not very many families could reshuffle at those rates for very, very long.

Chairman NICKLES. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Let me first talk about something the Chairman has mentioned several times about the tax rate on capital, and, Dr. Hubbard, you just mentioned it.

CBO did an analysis of this question, and it is in their latest budget book on Page 26: "Effective marginal income tax rates 2001 to 2013." They are not 60-percent effective rates, they are not 50-percent, they are not 30-percent.

Effective tax rates on capital 2003, 15.5; 2004, 15.4. Those are, according to CBO, effective tax rates on capital, including individual income taxes and corporate income taxes.

Let us turn to the question of economic growth because that really is the key, I think, Mr. Chairman, as you quite rightly have said before.

Are you familiar with Macroeconomic Advisers, Dr. Hubbard?

Mr. HUBBARD. Yes, of course.

Senator CONRAD. I take it you have respect for them.

Mr. HUBBARD. They are a certainly very well-known econometric consulting firm.

Senator CONRAD. This is what they wrote about the President's plan: "Initially, the plan would stimulate aggregate demand by raising disposable income, boosting equity values and reducing the cost of capital. However, the tax cut also reduces national savings directly, while offering little new permanent incentive for either private saving or labor supply. Therefore, unless it is paid for with a reduction in Federal outlays—" which the President does not propose "—the plan will raise equilibrium real interest rates, crowd out private-sector investment, and eventually undermine potential GDP."

Let us just put up graphically what they are talking about here. What this chart shows is the black line is the President's policy, and it does show a spike up in 2004, but then it plunges and is below the rate of growth that we would get if we did nothing for 2005 and beyond.[1]

This same group—and then I will ask you to comment, Dr. Hubbard. On the cost of corporate capital, Dr. Hubbard, you have testified that the President's plan will lower it 10 to 25 percent. That is what I heard you say. If I have got it wrong, please correct me. Their analysis shows something quite different. They show on the cost of corporate capital a reduction of 2-1/2 percent, not 25 percent, 2-1/2 percent in 2003, but then rising dramatically so that in 2006 the cost of corporate capital under the President's plan is increased by approaching 7 percent. The cost of corporate capital, because of the President's plan, is increased from, actually toward the end of 2004, right through 2017, cost of corporate capital is increased.

Dr. Hubbard, obviously you have a different take. You say that this is going to reduce the cost of corporate capital. They say it is going to increase it. I guess that goes to the heart of the debate. What is your response to what these respected economic consultants are saying?

Mr. HUBBARD. Sure. If I could take the two parts of your question, Senator. Going back to the issue of effective tax rates, I will look at the CBO table. That is at variance with work going back to Feldstein, Poterba and Dicks Mireaux in the early 1980's. In any event, what matters for securities markets is the tax treatment of the marginal investor, not average effective tax rates.

[1] Table not available at press time.

On the issue of the models, I think you are learning a lot about model assumptions as much as you are about model output. Let me connect the point you made about GDP and the point you made about cost of capital. You are alluding to a model in which the principal channel for tax policy is changing disposable income, and a model in which interest rates are very responsive to changes in saving.

On the point of the structure of the model, I think most economists would view that there are channels for tax policy to affect the economy far greater than disposable income. For example, in such a model writing checks to everyone has identical effects to changing marginal tax rates. We do not believe that as a profession. That is to say there are very few supply side channels in such models.

Second, I just do not buy the interest rate sensitivities, and rather than getting into an economic discussion, let me just try to shape some intuition. We just had a major swing over the past couple of years in CBO forecasts about the long-term surplus. That is what we started out our discussion with. We have the lowest nominal and real interest rates in quite some time in the United States, which is to say there is lots going on in a world capital market, and the notion that fairly small changes in U.S. Fiscal policy have dramatic effects on the world real interest rate, I do not buy. So what is giving you both the GDP effect and the cost of capital effect are exactly that.

The work we have done at ECA, the work Allen Sinai has done at Decision Economics, the study the Business Round Table put out, both have very large and persistent effects on GDP and reductions in the cost of capital. I am afraid you are just rediscovering the old problem that economists just do not always agree.

Senator CONRAD. I will grant you that. I will tell you one other thing, if I could say this, Mr. Chairman, is you have an assumption on page 8 of your testimony. "Another important assumption is that the estimates discussed above assume no changes in the stance of monetary policy." That is what I have a hard time believing. We have Chairman Greenspan saying to us deficits do matter, that if you run up significant deficits, that that inhibits their ability at the Fed to have a more accommodative monetary policy, and that is his testimony before Congress as well as personal statement to me.

So the bottom line is we have got a very significant disagreement between economic experts. You are asserting you are going to get stronger economic growth. Others, respected economists, say that you will actually hurt long-term economic growth with this plan because of the dramatic increase in deficits and debt, the upward pressure that puts on interest rates, the additional cost of capital that results, and therefore, what we wind up with is less investment and lower economic growth.

Mr. HUBBARD. If I might, Senator, on those points—of course I do not comment on monetary policy, but I will say that if you put familiar monetary policy reaction functions like a Taylor Rule into what we did, you get much the same effect early on. Where these models are generally unreliable is in the out years. We are also very conservative because the calculations we did assumed a zero stock market effect, so we have deliberately tied our hands behind our back.

Chairman NICKLES. Thank you very much, Senator Conrad.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

I thank you, Dr. Hubbard, for joining us today. The comments, and I read the expanded comments that you did as well, are extremely helpful in understanding some of the different relationships. Any time that we talk about taxes we are talking about probably the most complex thing in the United States, and I think you did a good job of explaining some of those things. We just got the budget materials yesterday. I have been trying to wander my way through there. There are some 2,700 pages involved in the information that we have got, and I found it all to be, everything that I have been able to go through to be extremely helpful, but not enough time. Of course when we do the budget process, I have already found in my short time on this committee that everybody in America thinks that we are actually doing appropriations, and I am having a little trouble conveying the difference between budget and authorization and appropriation, and trying to get them to understand that we do not look at every program and every line item, that that is the job of the appropriators, that we are trying to come up with a blueprint that is much more general and a little bit more focused on the policies, although I am kind of fascinated with some of the policies that we kind of tie our hands with at the same time.

As an accountant it seems a bit cumbersome and in some cases counterproductive. It is not a simple math problem where we are just adding and subtracting numbers. It is a complex issue that requires policy decisions. This is the policy, the group, as we make these financial analyses, and I am hoping that we have enough help on staff to be able to grasp, and through people like you that are testifying, to grasp some of the complexities of these things.

Then it gets a little bit more complex because each of us that are here each has our own opinions based on past experience and desires on what could happen.

I was very pleased to find in the budget that there is a performance review. I knew that there was a Government Performance and Results Act. I have done some auditing of agencies using that myself. It is a very good way for a person to learn about the different agencies, and I was glad to see that incorporated in the budget, and noted that a lot of the programs, while they are not suggested to be eliminated, are noted as being ineffective. I guess that would be a note for us to perhaps make some policy that there either be some changes in the program or elimination of the program. At any rate, I am glad to see that performance review.

I like the idea of the employment bonus that is in there too. I think that can have some pretty good effects for States and employment, which really kind of brings me to the heart of the matter and my love, which is small business. If we are going to employ people faster and we are going to have growth, we really ought to be relying on that sector of the economy that provides the most growth and absorbs the most employees and provides them with employment, which is small business.

So the question that I am getting to here is to find out why there would not be more of an emphasis on dividends for small business. The reason that I bring this up is even before the President made that proposal as I was traveling around Wyoming, I have had a number of small corporations, they did not go the Subchapter S route, they went a full corporation. Under that mechanism we are able to accumulate more capital for their business more quickly. As the business matures, then they wind up with these dividends that they really ought to get out, but they are somewhat irritated that they have to pay taxes on them twice. They know they already paid on them when they were growing the business. Now they have to pay on them when it is released to them as individuals. So it is not a new problem that just came up as a result of the President mentioning this. It was something that small businessmen with regular corporations have been mentioning to me for a long time.

Capital is always a problem when we are starting a new business, and I noted Senator Conrad's comment that the tax on capital was 15.5 and then 15.4 percent. I think that chart probably refers to capital gains as opposed to overall capital. I would be interested in seeing that chart in some more depth because there is a big difference between what you get charged on the dividends that you receive and the capital that you get from selling your stock. Most of these small businessmen that I know are not interested in selling their stock. They want to continue to do that business, but they have some other investments they would make if they could get their dividends out a little bit faster without having to give quite as much to the Government a second time.

So my question is: should there be more of a concentration on what can be done with small business? The proposal would apply to all businesses I assume.

Mr. HUBBARD. Well, I think there is two very important small business channels. First for the small businesses who are paying taxes on the individual system, the rate cuts are not only increasing after-tax income, but a real cut in the cost of capital and cost of hiring workers for small businesses. For the C-corporations that you mentioned, there are two effects. One is by eliminating the dividend tax on excludable dividends, but also the buildup of retained earnings. What the President is proposing is not just eliminating the dividend tax, but if I am a small business owner and I am growing the company and plowing money back in, I get continuous basis adjustments. So if I do wind up selling out, then I do not have to pay capital gains tax on those accumulated retained earnings. So we think this is very small-business friendly, and the same tax policy that is very good for large business is in this case good for small business.

In addition for small businesses, the expensing changes the President has proposed are very much pro investment.

Senator ENZI. Thank you.

Chairman NICKLES. Senator Enzi, thank you very much.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Chairman Hubbard, welcome. I have questions about the dividend exclusion issue with regard to corporate governance. I have many of the same questions that Senator Conrad asked with regard to return on capital because I have a hard time understanding where payment of dividends, where 50 percent of them roughly are going to non-taxpaying entities is going to dramatically change the return on capital. I can see at the margin it has some improvement, but just back of the envelope kinds of calculations. I do not see how it gets in the 10 to 25 percent range, and I frankly would love to see how that mechanism works. It does not jive with any of the economic discussions that I am hearing.

The corporate governance issue, I question why dividends are going to change the investor community's review of what the return on capital is, after-tax return on capital is, of a business any more than where they are today when they look at the use of capital. Then I put that in conjunction with, which I think is explaining what Senator Conrad was talking about, at least with the model that reduces rates of return over the long run, is you take cash off a balance sheet, encourage that and put incentives on that as opposed to retaining it, and I think what you do is have a lessened ability to actually form capital. You certainly cannot retain or hire employees if cash is flowing off the balance sheet. You cannot go to the bank and place a margin down. You cannot go to the rating agencies and suggest that you are going to be in a solid position on how you approach it.

Now, I do not particularly like double taxation on dividends either, but I believe that if you wanted to have, as the Administration has stated, and you wanted to encourage capital formation, but you also wanted dividends not to be prejudiced relative to interest, you would do it against taxable income on a company's balance sheet because it is no difference than interest not being taxable. So I would love to hear your comments on that. If we have a second round, I have a series of questions I would ask about State and local budget crises that also impact tax rates. Property taxes in this country are rising very, very sharply because of the budget problems that we have in our State and local Governments. Was that taken into consideration when the package that was put together to so-called stimulate the economy or create a growth package, did we take into consideration the estimated 70 to $90 billion budget deficits that are occurring that are causing an aggregate tax increase at the State and local level that is really quite substantial?

I could go into other undermining tax bases, dividend exclusion, and tie it to the Federal Tax Code, or the competition that excluded dividends have with a very select group of investors who might be a buyer of municipal bonds.

Mr. HUBBARD. Four very good questions. Let me try to go over each of them, first the question about whether there is any marginal effect. First, I would be happy to give you the paper that has all of our calculations and how we did it if you like, but let me get to the core of your question, which was the importance of non-taxpaying entities. What counts is the marginal investor, and most of the work we have by empirical researchers in finance is that the marginal investor is probably a high tax individual from our home town, and so basically the high tax individuals are more likely the marginal investors setting securities prices. So even if the vast majority of dividends were received outside of that investor, as long as he or she is at the margin——

Senator CORZINE. I might just ask a what-if question since we are running a current account deficit of, I do not know, 450 billion, 485 billion. You know the number better than I do. It strikes me that the marginal investor is not even a U.S. investor.

Mr. HUBBARD. Well, the marginal investor may also be other taxable investors, that is true. These policies are actually——

Senator CORZINE. That is exempt in the context of——

Mr. HUBBARD. Well, again, that is not the evidence that we have from the empirical work people have done on securities prices. For corporate governance, I guess there are really two effects that get at your question. One, much of the wind in the sails, as you know very well, in financial engineering transactions, comes from the asymmetric treatment of debt and equity and from timing differences. That is the wind in the sails from many tax planning transactions. Most, though not all of those, would be eliminated by the President's proposal. The idea here is not to bias toward paying dividends. It is not to force money out of corporation solution. It is to make sure that business people are making decisions as business people under business judgment and not the tax code.

We both know there are causes in which retained earnings may not have been used to the highest value of shareholders, and were there to be neutral treatment, the pressure from institutional shareholders, from capital markets generally, is probably very healthy. So we are not arguing for biasing for dividends, simply not being biased against dividends. The President's proposal would have them neutral.

On the issue of corporate versus individual, the key principle the President was after was taxing income once, and to do that in the context of share holdings in the United States, it is really easiest to do the relief at the individual level. I might note that the Treasury Department and the American Law Institute studies have also focused principally on individual relief, so it is not simply something the Administration had done.

On the issue of State and local, we have——

Senator CORZINE. There is a big debate in the economic literature I think over time about where you bring in the most efficient way. I think I even read a paper that you wrote in the 1980's with regard to the subject where you presented both sides of the case.

Mr. HUBBARD. It was certainly both sides, the issues. The bang for the buck is much smaller doing it at the corporate level because you are incurring a great deal of extra cost, and the marginal effect is the same, so the bang for the buck is smaller. So again, in terms of the use of scarce resources, that was our thinking.

On State and local, two issues that you raised. One is the scale of State problems, and they are significant, no doubt about it. The view the President had was that this is not the time for a one off aid to the States. Most of the State issues are structural. There are elements in the President's budget, as you are aware, in Medicaid, education and other areas that are additional funding for the States. We believe the President's proposal not only does not make the State situation worse, it makes it better.

Your question alluded to effect on the tax base of say removing dividends. So if I am a State that piggybacks off the 1040 structure, am I not worse off? Well, no. We have estimated State-by-State income responses to higher growth, and find that State revenues in total would be $6 billion higher. The loss of dividends from the base is 4 billion, and we would be happy to get you those State-by-State.

Senator CORZINE. Thank you.

Chairman NICKLES. Senator Corzine, thank you very much.

Next, Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman. I thank you for this hearing.

Dr. Hubbard, one thing I have thought about some recently, and I will just ask your view of it. Generally our economy does better when our major world trading partners are healthy. How are the major world economies doing compared to the United States at this time?

Mr. HUBBARD. You raise a very important point, also getting back to Senator Corzine's question about the current account position in the U.S. We have a situation which it is hard to have applause with one hand clapping, and the one hand is our economy. As rocky as things have been, we have been more of an engine. The Japanese economy, as you know, is in quite significant distress and unlikely to grow over the next couple of years. The Euro zone not only has large structural problems, it has issues relating to monetary policy constraints on its growth. In the short term emerging markets are not likely to be high sources of growth, so we have a situation in which for the near future the U.S. economy is the engine of growth. A key part of the President's agenda is the promotion of growth around the world. I know that our newly confirmed Treasury Secretary will be carrying that message to industrial countries and to emerging markets alike. So we agree that is important. We want to encourage better, more pro-growth economic policies in Japan and in Europe and in emerging markets as well.

In the forthcoming economic report of the President, if I can tout one of our home products, will have a chapter detailing the President's agenda there.

Senator SESSIONS. I think that is important for us to remember, and many of these economies have great potential I think, but the have more taxes, more regulation and less committed to the free market. I am convinced that that is a factor in their being less competitive than we are. Do you have any thoughts on that?

Mr. HUBBARD. Absolutely. If you go back to the first remark I made about the long term for the U.S., there has been a lot of introspection about why productivity growth in the U.S. is higher than it once was. More interesting I think to me as an economist is why it is so high relative to our trading partners. We are not smarter than the Europeans and Japanese. We do not have better technology. We all know cell phones here are worse than they are in Europe. It cannot be that. What it is, is our policies, our institutions that promote flexibility in allocating capital and labor, and that is something we should never take for granted. I think that is something we can export in the sense of having a pro-growth mission for the world.

Senator SESSIONS. Well, I would agree with that, and I hope that the world could see that as the State takes a larger and larger percentage of the net wealth of the economy, I think it depresses the private sector. I think what the American experience has been is that the private sector is what drives our growth, creates jobs, makes us productive, allows us to be able to spend $15 billion in Africa for AIDS or lead in many other areas of the world that other nations are not able to do because their economy is not as healthy.

Let me ask this. One thing that you mentioned in your written remarks on page 13, I think is important. These numbers that you have come up with are consistent with what I have seen others say, that this package that the President has proposed would produce a growth of almost 1 percent in GDP next year, by the end of 2003, and that by the end of 2004 it would be 1.7 percent increased GDP, more than if the growth package were not passed. Then you talk about the number of jobs which would be created from just that much increase in growth. Would you talk about that, please?

Mr. HUBBARD. Absolutely. The President called this the Jobs and Growth Initiative for a reason. We can go back to that long-term story again. Productivity growth being high is a great blessing for our economy, but it means something else. It means as an economy we have to grow more rapidly than we might once have had to grow to increase employment. That is very much of the President's mind. The GDP effects of this proposal, we believe, would lead to about a half a million extra jobs in 2003. These are new jobs that——

Senator SESSIONS. That is this year.

Mr. HUBBARD. This year, that would not have existed, and close to 900,000 in the next year. Over the long term the structure of the President's proposals raise all of our incomes through their effect on capital formation and economic growth. So this is very much a jobs initiative. As your question suggests, we get jobs in the American economy by promoting growth in the private sector and that is what the President is trying to do.

Senator SESSIONS. One more. Well, Mr. Chairman, I will turn it back over to you, and would just say to me, our challenge is to continue to strengthen and unleash the engine of the private sector that has made America the envy of the world. If we keep working on that and do that, I think we will work our way out of the financial difficulties we are in today. If we burden down the private sector with more and more taxes, we take a larger and larger percentage of GDP in the form of Government which inevitably is less efficient than the private sector, then I think we have the danger of a permanent slowdown as Germany has seen, as Japan has seen, and to me that is the big challenge. In this crisis and difficulty that we are in, we want to create jobs and vitality in the private sector, and not create a large and dominant bureaucracy in the central Government.

Thank you.

Chairman NICKLES. Senator Sessions, thank you very much.

Dr. Hubbard, a couple of quick comments. I have yet to hear of an economist—I am going to download this economic group that Senator Conrad alluded to, and maybe see if they are defending double taxation of dividends. Let me just ask you a couple of questions because I am interested. I do not know why anybody or how anybody can really defend it, but you correct me if I am wrong. I used to run a corporation. I want to distribute, let's say hypothetically, $100,000. We have retained earnings and we are willing to give it out to our shareholders. That is what we would like to do. We would like to give it out to the owners. If you do so in the corporate world today, a corporation has to pay tax on it. Maybe some people are able to escape that, and if they know something I do not, that is interesting. A corporation that is a taxpaying corporation that would distribute that $100,000, they have to pay corporate tax on it. Today that tax rate is 35 percent. So they want to distribute $100,000, but OK, after taxes they are left with $65,000. They distribute the $65,000 to the owners, and the owners have to pay taxes on it, and let's just assume it is a 30 percent tax bracket, and so $22,000 of that would go to the government in taxes, so the net result would be the Government would get $57,000 and the individual that you are trying to distribute the earnings to, would get $43,000. Is that correct, the Government would actually get more of that distribution than the owners?

Mr. HUBBARD. That is correct.

Chairman NICKLES. Now, conversely—and I would like for Senator Corzine to catch this—conversely the present tax code says, all right, well, bonuses are fine. You can deduct bonuses. There is no limit on bonuses, and so we will grant the $100,000 bonus, the corporation gets to write off that, and so the net cost to the corporation is not $100,000, assuming they are profitable—if they are not profitable this does not make sense—but if they are profitable, the net cost to the corporation of paying the $100,000 bonus is $65,000. The individual gets the $100,000. The individual pays the taxes on the $100,000, let's assume $30,000, and so the Government loses money from the corporation taking the deduction. The individual pays the taxes, so basically you have a distribution on the bonus where the Government just about comes out even, and maybe lose a little bit because 35 percent is higher than 30 in this hypothetical, but it could be the same. So the bonus transaction works out really well. But dividend distribution to the owners is a really crummy deal. So certainly in a closed corporation or one where managers can say, well, we will distribute cash payments through a bonus type system, it makes eminent good sense, and it makes very little sense to distribute dividends to the owners. So shareholders really come out on the short end of the stick. Maybe people that might be recipients of some type of bonus plan would come out very well.

I just think the present tax code is really skewed against shareholders and it is very biased toward debt. If you are making a debt vs. equity decision, if you need new capital, you are going to issue equity or you are going to go to debt, the present tax code screams at you to go debt, and you have a lot of corporations now that are struggling with that. So I just mention those. If my examples or hypotheticals are not accurate, you could please correct me.

Mr. HUBBARD. No. I think they are very accurate, Mr. Chairman, and they point out the basic problem, that we have created a situation in which we want business people thinking as much about tax planning techniques as they are about real business. That is not only a waste of their time, it is a waste of resources for our country.

You asked whether people could not support eliminating the double tax in dividends, the principal disagreement on the other side would be if you thought neither investment nor saving is responsive to changes in the rate of return, then doing this is not a good thing. I am aware of very few economists who believe that, but that would be a principal argument.

I think your questions also raise the sense in which this is an important short-term concern for the economy, too. I know there is a tendency to think of this aspect of the President's proposal as being simply about the long-term—interesting tax policy but a long-term question. Again, particularly in light of the corporate governance scandals and particularly in light of high hurdle rates on investment, we believe it is important for the short term as well.

Chairman NICKLES. Thank you. I want to touch on one other issue that hasn't come up. Senator Conrad had a chart that showed enormous red at the bottom of it and showed deficits just climbing out of sight. I am guessing that assumes a lot of things. I want to look at maybe the long-term debt projections that you and your office have, and I haven't really looked at those that closely.

I will touch on one program that I think Senator Conrad and I are concerned about long term, and that would be Medicare. The Administration is working on a proposal that not only would provide enhanced benefits, i.e., prescription drugs, catastrophic, preventive care, lower deductibles, but it also is talking about trying to reformulate the program to make it competitive and affordable and successful, that would help salvage the program and save the program for the long term.

Would you care to explain that? Many people characterize it, well, yes, what the Administration is trying to do is make you join an HMO if you are going to get prescription drugs. Would you care to comment on that?

Mr. HUBBARD. Sure. Well, I don't want to go through the details of the plan because it is in progress. To get at your question, I think what the President is trying to say is, look, of course, we should have a prescription drug program in Medicare. It is crazy that we don't. The question is: Do we want a Medicare system that is modernized, that improves quality and choices for seniors?

In terms of your principal concerns here on the budget, I would say two things about Medicare: one, our economy's ability to make good on our promises that we have rightly made in Medicare and Social Security and other programs is to have the economy growing as rapidly as possible. As the budget points out, the real fiscal issues for our country are not the short-term wiggles in our budget deficit, because with the proposals we have, with the very conservative assumptions we have in the budget, the debt in the hands of the public relative to GDP is still stabilizing in the out-years. That is not an issue.

The issue is the entitlements programs. When we take a look at Medicare, we have to make sure that we start with the medical maxim of doing no harm. Yes, we should add a benefit, but we don't want to do so in such a way that actually jeopardizes the program. That is what the President will try very hard to do.

Chairman NICKLES. Thank you very much.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Dr. Hubbard, would you say that the new Secretary of the Treasury, Mr. Snow, is somebody that has a good understanding of how the economy functions?

Mr. HUBBARD. Absolutely.

Senator CONRAD. I am glad you said that. Let me just put up his evaluation back in 1995 dealing with these questions we have been talking about. He said then, "A credible, sustained reduction in Federal deficits leading to a balanced budget will bring major economic benefits. As the Government spends less and borrows less from investors to cover declining deficits, more capital will be available for investment in the private sector of the economy. Inflationary pressure will ease and interest rates will respond by declining as much as 2 percentage points."

Now, I quote from him because I believe he has got these relationships right. Now, the President comes before us and has a proposal that explodes deficits. This is from the document, "Analytical Perspectives Contained in the President's Budget for Fiscal Year 2004," and it shows deficits as a percentage of GDP, it shows these are the good times because we all know what is coming—the baby-boom generation, and then the deficits and debt explodes. This is according to the President's analysis.

So if Secretary Snow was right that reducing deficits has major economic benefits, I can only conclude increasing deficits hurts the economy. We are talking about huge, massive deficits going up approaching 15 percent of GDP in the out-years here.

You know, it is what takes me back to what other economists are saying, that the plan that the President has sent us does not give us much boost in the short term. The Democrats' plan has much more stimulus short term. That gives us more economic growth this year when the economy is weak. Because it doesn't have these out-year additional costs, as does the President's plan, it doesn't do damage by raising deficits, raising debt, that reduces societal savings, that reduces the pool of money available for investment, that retards economic growth.

So, you know, I have looked at all of these analyses that we have available to us from respected economists, and there is such a divide, those who say that your plan will actually hurt long-term economic growth.

I must say, I look back to the 1980's and the 1990's. In the 1990's, we reduced deficits and we had the longest economic expansion in our Nation's history. I don't quarrel with providing stimulus at a time of economic slowdown. It does strike me that adding to deficits and debt in the coming years, when the baby-boom generation is about to retire, is going to explode the debt and hurt the economy.

That is the nature of this debate and this disagreement, and, again, I will certainly give you a chance, if you want, to respond to any of that.

Mr. HUBBARD. Sure. You actually raise several questions. Let me start near the end of your questions and remarks with the notion that we reduce deficits. Let me go back to the story of the economy's boom and downturn.

We got very good news in the 1990's about our economy's expected ability to grow. That raised surplus projections. It raised our current incomes. It also raised real interest rates. In other words, if the sign goes the other way, theory would tell you that good news about the future raises both surpluses and real interest rates. When we got a sense that we may have been overly optimistic, we see surpluses declining, current income declining, and interest rates declining.

On the notion of John Snow's comments, let me not put words in John's mouth. You can ask him. Having had this conversation with him many times, I think his view, very similar to my own, is that what is very important is to stabilize spending, precisely the priority that he mentioned in the statement you attributed to him. The reason for that is principally because the ultimate claim on the resources of society from Government is from the size of Government. It is our taxes today or our taxes tomorrow. There is a significant body of work in economics, most notably by Robert Barrow, who is a Harvard professor, suggesting that countries with very large governments have lower rates of growth. This isn't a question about whether they are deficit-financed but a question of the size of government, and limiting spending was and is a very important issue.

On the issue of balancing the budget, you know, we could have a balanced budget in the United States relatively quickly. It is a question of our priorities. If you wanted a budget that did not have improvements in homeland security and defense, did not have Medicare modernization, and did not have a growth package, it would be possible to have a balanced budget very fast. We all know that fiscal responsibility is very important and a balanced budget is important. So are other things. The question is priority.

The President puts the priority on growth and spending restraint as being the issue, and I think that is where we may just have a difference of opinion.

Senator CONRAD. I would just conclude by saying that is correct. I don't see that the President has put any priority on balancing the budget or reducing deficits. Just the opposite, his plan is to mushroom deficits and mushroom debt at the most inopportune time—right before the baby-boom generation starts to retire. He is going to present a future Congress, a future administration, and future generations with a chasm, a fiscal chasm, and then we are going to see really tough choices. That is to me a profound mistake.

Mr. HUBBARD. We obviously, of course, don't share that in the Administration, Senator. The view is that the effects of the President's proposals on economic growth are very much in the country's fiscal interest just as much as they are in GDP.

I neglected to mention—since you showed the chart comparing the Democrat and Republican plans, let me, without commenting on any model, just make a fairly general statement. I know of very few economists—and I will say very few economists—who would suggest to you that the kinds of temporary tax changes that have been in most of the Democratic proposals will have a very big effect on the economy. We have a widespread research on this in economics, from Democratic economists and Republican economists. This one just isn't that controversial.

Senator CONRAD. Well, I would say to you that none of these stimulus plans have much effect. Truth be told, the plan the President has advanced does not, according to a wide spectrum of economists, including the Administration's own claims.

The one thing we know is it explodes deficits and debt. Another thing we know is the baby boomers are getting ready to retire. Then the huge surpluses that are being thrown out by the trust funds are going to turn to massive deficits. That is going to present this country with truly difficult choices.

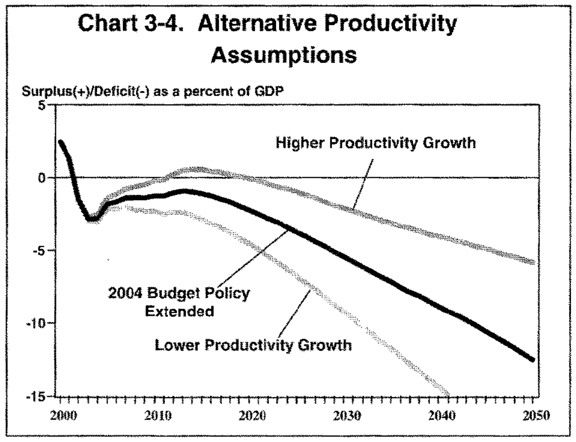
As the head of CBO said last year in testimony before this committee, it is going to present this country with choices of unsustainable debt, unprecedented tax increases, and/or the elimination of the rest of the Government as we know it. That is pretty draconian.

Mr. HUBBARD. If I may, Senator, that is, of course, a statement about the entitlement programs.

Senator CONRAD. Correct.

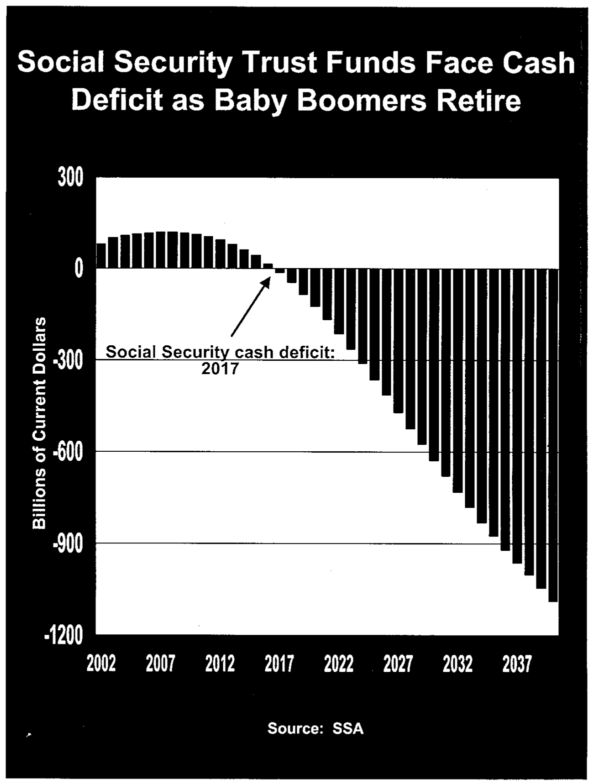
Mr. HUBBARD. As a statement, that is correct. The President's proposal does not lead to mushrooming either deficits or debt-to-GDP ratio, and I would invite you to look at the budget and the pictures in the budget which plot debt-to-GDP ratios. We believe those are actually conservative, that the revenue feedbacks from the President's proposals are actually quite substantial, although those are not portrayed in the budget.

Senator CONRAD. I would just draw your attention to page 43 of the President's "Analytical Perspectives." This is what it says: "2004 budget policy extended, debt-to-GDP explodes." That is not my chart. That is from the President's "Analytical Perspectives."



Look, I don't know how it can be otherwise. I mean, if we look at—look at the Social Security chart, where we are headed. We know that the trust funds are running big surpluses now. The

President is taking all that money and using it to fund tax cuts. You have got over $2 trillion out of Social Security surpluses in the next decade to pay for tax cuts and other expenses of Government. That is when the trust funds are running surpluses. Here is what is going to happen. We are in the sweet spot now. We are up there in the green. This is where we are headed. The baby-boom generation is coming. We have never seen this before. That is what is going to mean these extraordinarily awkward choices, and I think it is just a terrible mistake.



Chairman NICKLES. Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman. I didn't realize we were going to have such strong support on balancing budgets, and we may be able to go further that way than I ever thought that we could, because I have always had some concern about trying to spend ourselves into prosperity. There is a great opportunity any year that we look at the budget. Everybody kind of drools over the possibilities of new programs that we could do and new spending that we could do, and I understand how we can't just take a couple of trillion dollars, although that is an awful lot of money, and add a few billion to that and think that we can change the world.

What I am curious about is: Should we be putting our money into programs or into investing in ourselves? My Grampy used to always say that you even had to be careful investing. He said, "Never own anything that can eat while you sleep." [Laughter.]

Senator ENZI. That has been pretty good advice to me, but that is because the expenses keep going and the investment isn't there to back it up.

Are you saying that with the President's proposal what we are talking about with the tax cut is actually getting increased investment?

Mr. HUBBARD. Yes, Senator. First, in the sense of business investment, capital investment, we believe it is very pro-investment, the rate cuts, the expensing provisions, elimination of the double tax, but also for human capital investment. As your question was hinting, a big kind of investment we do is investment in ourselves, and there is a large and growing body of work in economics suggesting that high marginal tax rates can also discourage that investment and discourage risk-taking and entrepreneurship. So the President's plan is very much centered on all these margins.

Senator ENZI. I think you were also getting at the difference between some tax cuts that would last over a period of time versus giving cash. Would you expand a little bit on your comments between expanding this 10-percent tax bracket and giving a one-time cash benefit to everybody?

Mr. HUBBARD. Well, certainly we—if you are a consumer, you are going to respond very differently to somebody giving you an amount of money, say $300 once in a check, and somebody telling you I am going to give you $300 a year forever, as if it were an annuity. That is intuitive to us as individuals. It also happens to be borne out statistically. People respond only between a third or half as much to temporary changes.

So if the notion is you would like to shore up the consumer, if that is the goal, you want changes that are enduring, the President's policies have that advantage. They are accelerating rate cuts you already passed. They are already in the law, and so they are not just one-off changes. One-off changes have an odd fine-tuning feel about them. Going back to the beginning of your question, in Government, you know, we can't fine-tune the U.S. economy. We shouldn't kid ourselves that we can. What we can do is help the private sector have an environment for growth.

Senator ENZI. Thank you.

Chairman NICKLES. Senator Enzi, thank you very much.

Senator Corzine.

Senator CORZINE. Yes, thank you, Mr. Chairman.

I hear the argument repeated a number of times about high marginal tax rates stifling the economy and what we need to do to grow the economy is to adjust those marginal rates in lots of different forms.

For the life of me, I am having a hard time understanding how in the 1990's we created 22 million new jobs; we probably had the highest rate of entrepreneurship that we ever had in the history of the country, created more millionaires, worked on reducing poverty levels, and at least since we started cutting marginal rates, I actually believe that marginal rates were 80 percent. You would be right, when they are moving from 38.5 or 39.5 to 35, one wonders why we think we—and you talked about fine-tuning—why we thought that the tax structure that produced such grand expansion, basically the best expansion we had in the 20th century, created the kind of growth that actually allowed for paydown of deficits, needed to be tinkered with, fine-tuned so much that we ended up losing 2.5 million or 2.4 million private sector jobs certainly over the last 2 years. I am troubled by—I read on the White House's press release that we were going to produce 190,000 jobs in 2003, and I heard 500,000 today.

You know, I have the big question of what did we think was wrong with what was creating the kind of economic growth that we had with the tax structure we had. You know, I see some reform. I personally don't believe in double taxation of dividends. Again, we can argue about where that ought to be addressed. Why when we just came through one of those periods in history where we saw the most significant investment boom, the rise in productivity, 22 million new jobs, that we thought we needed to fine-tune the Tax Code from 39.5 down to 35 to accomplish some growth projections that there is among reasonable people, as we have heard today, significantly different views on what its impact on growth is going to be or certainly long-run national savings.

Mr. HUBBARD. Economists have a kind of annoying phrase they use a lot, which is, "All else equal," which is our way of saying we don't want the world——

Senator CORZINE. It is kind of like holding the money supply——

Mr. HUBBARD. We don't want the world to move while we are talking. One reason it is annoying when economists talk to people is because the world does move. There are very few clean experiments.

Now, I raise this because when you talked about the 1990's, it is, of course, not the tax structure of the American economy that led to the boom of the 1990's. We know that we got lots of good news about the productivity potential of the American economy. That was very good news, even though we had rising marginal tax rates in 1993. The good news for our economy was such that net-net we did very well. When you asked would we like to have that kind of growth forever, of course, we would.

There is a large body of work in economics, in labor economics, in the study of investment and the study of finance, to suggest that marginal tax rates not only discourage labor supply but entrepreneurship and risk-taking, small business formation. This is a vast literature covering data from the 1980's and data from the 1990's. You simply can't hold all else equal in the two experiments that you did. I wish economists had more natural experiments. We don't.

On the issue of jobs, I think if you look on the website, what you will see is two sets of numbers. They are often calculations presented on a year-to-year basis, that is, comparing annual averages. Fourth quarter to fourth quarter is another presentation. The 190 that you mention I think is roughly the year over year for the first year gain in jobs. The 510,000 is quarter 4 to quarter 4. That is over the course of a calendar year.

Senator CORZINE. You are talking about the rate of growth that you are expecting in——

Mr. HUBBARD. Over the course of the calendar year. I used that today because, frankly, I think it is more intuitive. I think it is easier to talk about growth over a period than comparisons of annual averages. You will find both numbers because I know people have fascinations with one or the other approach.

Senator CORZINE. Was there business investment in the 1990's? Was there entrepreneurial activity with the tax structure that we had? That increase was a part of the increase in productivity growth that we experienced in the 1990's, and also has continued on into the current environment?

Mr. HUBBARD. Well, let me give you the classic yes and no answer from an economist. Obviously rate of investment was very high in the 1990's. It is obvious we had good news. It was also obvious that we had too much investment in the 1990's. We had been working through a period of excessive investment. Part of that was because we were overly optimistic. We can miss things. Frankly speaking, the very biases in the Tax Code that Senator Nickles was referring to also created opportunities for some unwise risk-taking, some financial engineering, some lack of transparency in earnings and investment.

So while, yes, the 1990's had many very positive things about them, none of those positive things would suggest, to me at least, that it is not worth the candle to improve the tax structure.

Chairman NICKLES. Dr. Hubbard, thank you very much. I might mention, maybe if you would provide for the Committee—I mentioned to you this big reduction of revenue between 2001 and 2002, trying to figure out where did that go, because I know there was some irrational exuberance, as Alan Greenspan would say, when the market was going up, and I think that caused a lot of things—big bonuses, big payments, a lot of transactions that were happening that generated a lot of tax payments. When the market collapsed, a lot of that collapsed, and maybe that had really inflated the ride up and pulled out.

You have projected that we have bottomed, and you have projected an increase in revenues, I believe, between 2003 and 2004 of 5 percent, something like that. If you could give us—I am really interested in how that declined so dramatically and where was that reduction, if you have any analysis.

Mr. HUBBARD. I would be happy to give you all the details, Senator, but I can give you the Cliffs Notes version in short order. If you were to draw a trend line in Federal receipts relative to GDP, the story of the late 1990's is borrowing forward. We had a tremendous increase in revenue growth, partly because we have a very progressive tax system and incomes had grown very rapidly among the very well off, and a big increase in capital gains. We know that as the bubble burst, that went away.

I will get you all the details, but the largest answer is that is the key point.

Chairman NICKLES. I appreciate that.

For the information of colleagues, we have provided the disk for the President's budget so you won't be carrying those five or six volumes around with you all week. You will have that.

Dr. Hubbard, thank you very much for testifying.

Mr. HUBBARD. Thank you, Mr. Chairman.

Chairman NICKLES. I appreciate your response to our questions as well.

Mr. HUBBARD. Thank you.

Chairman NICKLES. For the information of members and others, tomorrow morning we will have the Director of the Office of Management and Budget, Mitch Daniels, to testify at 10 o'clock.

The committee is adjourned.

[Whereupon, at 4 p.m, the committee was adjourned.]

THE PRESIDENT'S FISCAL YEAR 2004 BUDGET PROPOSALS

WEDNESDAY, FEBRUARY 5, 2003

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. Don Nickles (chairman of the committee) presiding.

Present: Senators Nickles, Domenici, Allard, Burns, Sessions, Crapo, Ensign, Cornyn, Conrad, Hollings, Murray, Wyden, Nelson, and Stabenow.

Staff present: Hazen Marshall, staff director; Jim Hearn, senior analyst and Cheri Reidy, senior analyst.

For the minority: Mary Ann Naylor, staff director; and Jim Horney, deputy staff director.

OPENING STATEMENT OF CHAIRMAN DON NICKLES

Chairman NICKLES. The committee will come to order.

Today the Budget Committee will hear testimony on the President's fiscal year 2004 proposals. We are very pleased to welcome Mitch Daniels, the Director of the Office of Management and Budget.

Mr. Daniels has one of the toughest jobs in Government. I compliment him for the work that he has done. I have had the pleasure of knowing him. Prior to joining the Administration, he worked as senior vice president for Eli Lily, and he also spent 11 years working for our colleague Senator Dick Lugar. Director Daniels, we are delighted to have you with us as well.

First I will call upon my colleague Senator Conrad, if he has any opening remarks.

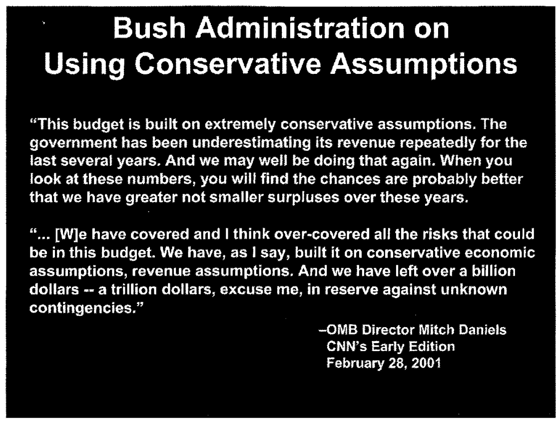
OPENING STATEMENT SENATOR CONRAD

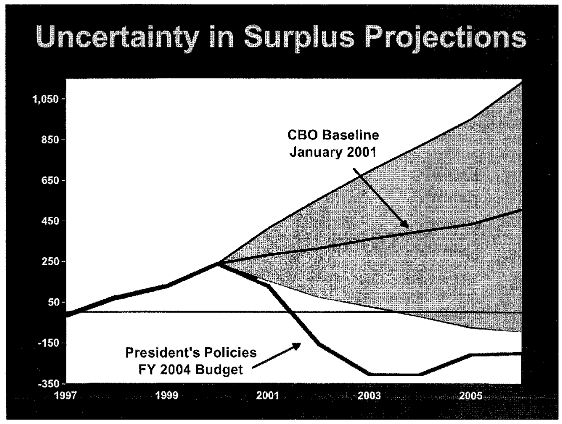
Senator CONRAD. Thank you, Mr. Chairman. Thank you for holding this hearing. Thank you to Director Daniels for being here.

Director Daniels, this is a budget proposal that we have strong disagreements about. We think it is going in the wrong direction, that it will build deficits and debt in a way that hurts our long-term economic strength.

Before I go into that, I think perhaps just a review of where we have been would be useful. I hate to bring you back to words that you have used before, but let me just go back to what you told us back in 2001. You said then that "the budget was built on extremely conservative assumptions; the Government has been underestimating its revenue repeatedly, and we may well be doing that again.

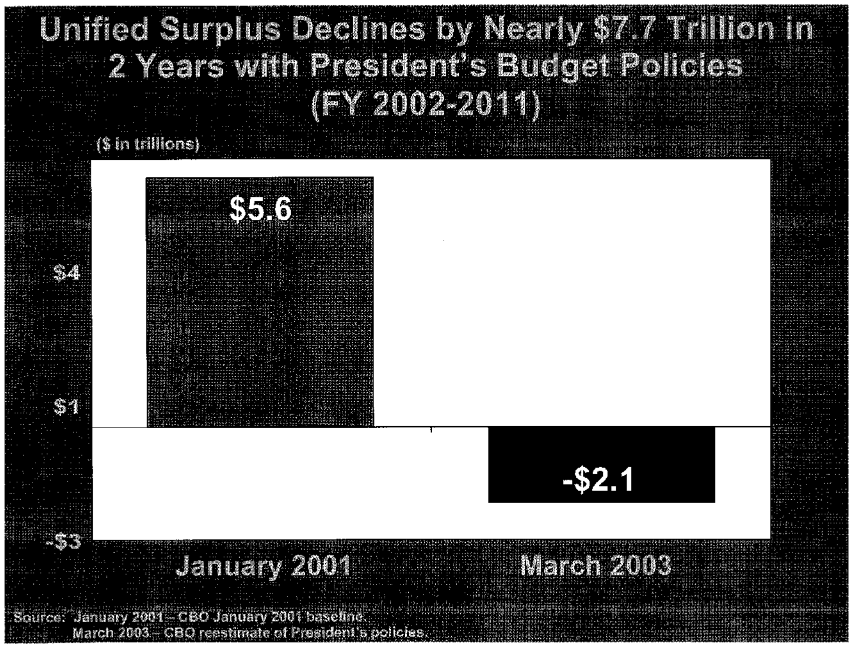
When you look at these numbers, you will find that chances are probably better that we have greater, not smaller, surpluses over these years."



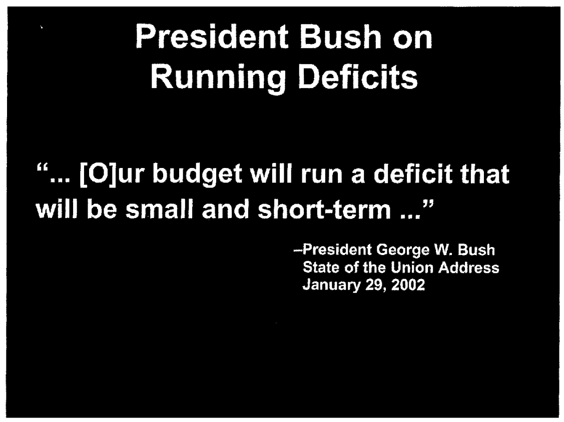


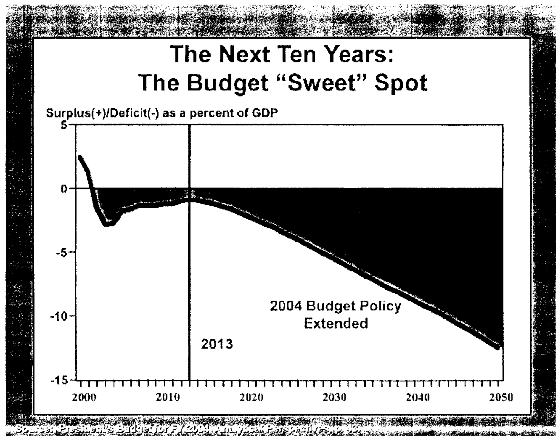
Let's go to the next chart and just look at the reality of what has happened. You will recall CBO had done this fan chart on likely outcomes, and the midpoint was based on the notion we would have almost $6 trillion of surpluses. In 2001, you were telling us that there was going to be even more money, in your judgment, than that.

Now if we go back and look at what has actually happened, we are below the bottom line of outcomes. Let's go to the next chart. So the result is that instead of $5.6 trillion of surpluses over the next decade, if we adopt the President's policies, we are $2.1 trillion in the hole. That is just over the next 10 years.

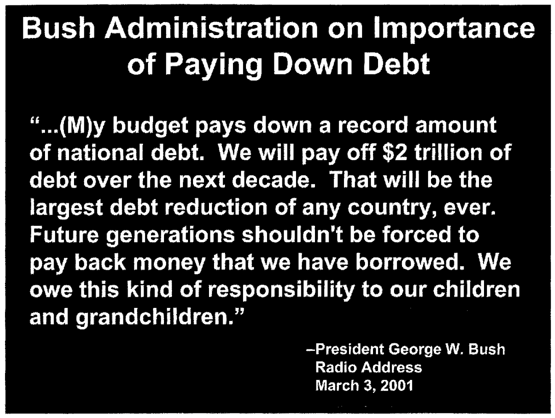

Unified Surplus Declines by Nearly $7.7 Trillion in 2 Years with President's Budget Policies
(FY 2002-2011)
($ in trillions)
$5.6
-$2.1
$4
$1
-$3
January 2001
March 2003
Source: January 2001 – CBO January 2001 baseline.
March 2003 – CBO reestimate of President's policies.

Let's go to the next chart. Last year, the President told us that the budget will run a deficit that will be small and short term. Again, we can now reflect on that and look at what is happening. This is what the President's budget is now telling us. We look at his document; it is the "Analytical Perspectives." This is a chart from the President's own budget book. We never escape from deficit, and the deficits mushroom geometrically if we extend the 2004 policies. That is what is in the President's budget book.

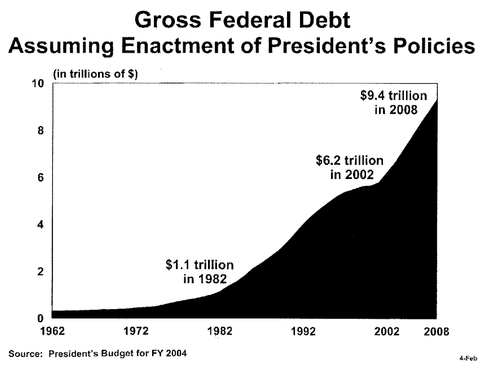




Let's go to the next one. The President told us back in 2001 the importance of paying down debt. He said, "My budget pays down a record amount of debt. We will pay off $2 trillion of debt over the next decade. That will be the largest debt reduction of any country ever. Future generations shouldn't be forced to pay back money that we have borrowed. We owe this kind of responsibility to our children and grandchildren."



Well, that is another statement, I guess, that is by the boards. Let's go to the next that shows what is happening to the gross Federal debt. It is not going down. It is going up, and going up dramatically. The same picture would emerge if we looked at publicly held debt. The President told us in 2001 we would pay off virtually all publicly held debt. Now we see by 2008 we will have $5 trillion of publicly held debt.



I guess the point of all this is that this game plan hasn't worked. It hasn't come close to working. What the President is proposing is more of the same—more tax cuts that are not paid for, that add to the deficit, that add to the debt, that put us in a circumstance where we never emerge from deficit as far as the eye can see. In fact, the deficits become so large that they are clearly unsustainable.

So that is my reading of the President's proposal. I think it is one we cannot adopt. We must find a way to move in a different direction.

I thank the Chairman.

Chairman NICKLES. Senator Conrad, thank you very much. I will put you down as undecided on the President's budget. [Laughter.]

Chairman NICKLES. Still some possibility, but slightly undecided.

I welcome before the Committee—I haven't had the chance to welcome—Senator Murray and Senator Wyden. Especially I want to say to Senator Hollings, whom I have had the pleasure of serving on this committee with for many, many years, and I think this is the first time you have joined us since I have been chairman, I am delighted to have you continue on the Committee. I appreciate your service on the Committee. On occasion we have worked together, and I hope that we can in the future. I say that to all of our members. I would love to see us do a bipartisan budget. It hasn't happened in many years. It will be a challenge. This committee is a committee that is a big challenge. We have lots of work to do, needless to say.

I want to avoid extended debate amongst members, but I do want to make just a couple comments since a couple of you have missed a couple of our previous meetings. Yesterday we had a meeting with Dr. Glenn Hubbard, the President's Council of Economic Advisers Chairman, and he did a good presentation. I had a chart that showed that revenues have declined 9 percent—8.5 percent over the last 2 years. We went from a little over $2 trillion, $2.025 trillion to $1.85 trillion, a reduction in revenues received. Because of that, we have enormous deficits.

Now, that was misjudged by CBO and OMB both, and it was caused by a lot of things. Maybe Director Daniels will touch on that. Part of it was caused by the stock market bubble bursting, and it was also caused by a terrorist attack, and it was caused by a recession.

So revenues have declined precipitously. We have never had in our history basically a 9-percent reduction in revenues. Because of that, we are behind and we have some deficits. So, in my opinion, to get out of this deficit situation we have to show fiscal discipline, but we also have to figure out ways to grow the economy. The Administration has put forth a proposal; they have put forth a budget. It is very important for us to pass a budget. So, Director Daniels, I welcome you. I am not going to ask other colleagues—if other colleagues are just dying to say something, I will recognize them. If not, I will recognize Director Daniels.

With nobody objecting, Director Daniels, welcome back to the Committee. I would appreciate your comments before the Committee. Please proceed.

STATEMENT OF HON. MITCHELL E. DANIELS, JR., DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. DANIELS. Thanks to the Committee for the privilege of being here. I have submitted written testimony, and in the interest of time, let me just extemporize for a minute or two and just pick out a couple of key points.

The President has sent what we call a budget. Obviously it is a program that comprises his sense of the Nation's needs and priorities. I think they are pretty plainly set forth. They begin with the defense of the physical safety of Americans, which now includes carrying not only a stronger and transformed Defense Department, but also carrying a war on terror to those who would harm us where they live. I will probably point out more than once today that the best homeland security money, to use our new term, that we can spend is that which we spend stopping terror before it ever gets to our shores.

Behind this, the new category we call homeland security, defending Americans against hateful people who might leak through. Behind that, action to invigorate the economy, an economy which has grown for five straight quarters but not at a rate the President finds adequate. Therefore, he made a considered judgment to act for the third time in his Presidency to try to stimulate greater growth and more jobs.

Yes, we forecast a deficit. There are two or three things that are important to note about this. One is that although its origins are sometimes misunderstood or misrepresented, they are really no mystery. They are: The recession that was on in the first quarter of 2001 wasn't known at the time that we all got together around those forecasts we inherited, just as we inherited the recession. Second, the attack of September 11th and the war and extraordinary costs, now over $100 billion, that nobody saw coming, or could have. The third phenomenon in a triple witching hour was the collapse of the stock market bubble. Now, that did start in March of 2000, but as far as I know, no one saw how far and how fast that would continue. If anybody did, they are a very wealthy person today, I presume.

Those three phenomena together put us into deficit, and just, as I say, to dispel one fiction, I have been reminding people that if the President's 2001 tax plan had never passed, if no tax plan had passed—and even those who opposed it at the time tended to favor some sort of tax relief. Let's pretend that none had ever passed. We would have had triple-digit deficits last year and this year and next year.

So people ought not be casual about the facts and trying to assign blame for something that really must be blamed on three circumstances that were not within the control of anyone here and, as far as I know, no one had a crystal ball so clear they could see them coming.

The most important objective for returning to balance, of course, is economic growth. It was economic growth and a strong stock market which brought about the last surplus. I would offer or try to offer a word of encouragement to Senator Conrad and others that they ought not give up so easily, because surpluses are the consequence of strong economies, not the other way around. They could return just as surprisingly as the last time. No one saw the last surplus coming, not 5 years, not 3 years, not 1 year ahead of time. Those forecasts were all for big deficits running on without end.

In fact, in the year the surplus arrived, 4 months in, both CBO and OMB and others were still forecasting a deficit. So just as we have learned how surprisingly quickly things can change in a negative direction, we ought to maintain the hope and the kind of policies that will make a very strong economy and, therefore, a return to balanced budgets much more likely.

I will end on one other point. Part of the proposal that the President has made is to reinstate the regime of budgetary controls that expired last year under the Budget Enforcement Act. We hope that this committee, which has taken so much leadership in the past in maintaining fiscal discipline in the Congress, will take the lead here, too, and help us to get back caps. We suggest them for 2 years, which we think is a realistic timeframe—2 years at the level of spending restraint, 4 percent, that matches the expected growth in family income that the President has proposed.

We thank you for the opportunity to be here, and I am happy to answer any questions.

[The prepared statement of Mitchell Daniels follows:]

TESTIMONY OF
MITCHELL E. DANIELS, JR.
DIRECTOR
OFFICE OF MANAGEMENT AND BUDGET
BEFORE
HOUSE AND SENATE BUDGET COMMITTEES

February 4-5, 2003

Thank you as always for the privilege of appearing.

This week we are presenting the President's program for Fiscal Year 2004. No such presentation lacks for long-term importance to our nation's future, but few in our history have directed the nation's public resources at more fundamental challenges.

The President plans to prosecute the war on terror relentlessly. There is no more effective way to protect Americans, or, as we now say, to provide "homeland security", than to root out terror and stop it before it can reach our shores. The President's Budget provides $380 billion for the war on terror and the continued rebuilding of our national security capabilities. Spending on domestic homeland security is also given top priority, with spending rising at the fastest percentage rate of any major category.

The President's third priority is to reinvigorate an American economy that has grown for five consecutive quarters, but at a rate that he deems far too slow. To this end the President proposes a major growth and jobs plan, the third of his Presidency.

Below these three transcendent objectives, the President urges greater spending on a host of essential activities: veterans' programs, the education of our disadvantaged and disabled children, the alleviation of Africa's AIDS tragedy, research on a pollution-free automobile, and so on.

The budget has returned to deficit, a phenomenon that pleases no one, but which ought not be misunderstood or overstated. Today's deficit, while unwelcome, was unavoidable, and is manageable. In fact, given a sputtering economy, it reflects appropriate economic policy, as the President decided in advocating a bold economic plan.

The deficit's origins are no mystery. It was the product of a triple witching hour in which recession, war, and the collapse of a stock market bubble coincided, presenting our country and government with a radical change of circumstances.

Let me pause to dispel a persistent fiction, or, more accurately, misrepresentation. Note this fact: If there had never been a 2001 tax cut, we would still be experiencing triple digit deficits today. Let me repeat: if those who opposed tax relief in 2001 had succeeded, and no bill of any size had ever passed, the 2002 budget would have been $117 billion in deficit, and the 2003 shortfall would have been $170 billion.

Even if we had never been attacked, and incurred no costs of war or recovery from September 11th, and no tax relief had become law, we still would have gone into deficit, as a consequence of the recession and the popped revenue bubble. There is no question about what got us out of balance; what we should be debating is the right way, and right pace, for getting back in.

Deficits are not always unacceptable. The strongest proponents of balanced budgets routinely make exceptions for war, recession, and emergency – exactly the conditions we have experienced simultaneously. In other words, there are times when it is necessary for the federal government to borrow in order to address critical national priorities.

These are such times. In proposing an aggressive economic growth plan, the President was consciously opting to accept somewhat greater borrowing in order to put more Americans back to work.

He did so recognizing that today's deficit is moderate, and manageable. It is moderate by any historical measure: at 2.7% of GDP, the 2004 shortfall will be smaller than in 12 of the past 20 years, and less than half the largest deficit in that period. It is manageable, in fact highly so, in that the costs of debt service are extraordinarily low. Just five years ago, interest payments took up 15 cents of every budget dollar; this year, thanks to the lowest interest rates in 40 years, it will be just 8 cents.

A balanced federal budget is a very high priority for this President. It is not, and cannot be, the highest priority, let alone the only one. He does not place it ahead of our national security, the safety of Americans from domestic terror, or a growing, full employment economy.

If a balanced budget were all that mattered, it would be no great trick to accomplish. By either CBO or OMB estimates, all we would have to do is to stop where we are, to hold our spending growth to inflation for the next couple years. But that would mean no action to create jobs, no new action to defend our homeland, no further strengthening of our defenses, and so forth.

The most important objective in this context is economic growth, the wellspring of balanced budgets. No one saw the last surplus coming: not five years ahead, or three, or even one. In fact, four months into the year of the first surplus, both OMB and CBO were still predicting a deficit for that year. A strong economy produced that unpredicted surplus, and only a strong economy can bring a surplus back. If we balance our priorities, we will balance our budget in due course.

The costs of a potential conflict in Iraq are not included in this submission. We all fervently hope that no such event will prove necessary, but if it should, we would present to the Congress immediately a request for the funds estimated to be required to enable a decisive victory, a secure and compassionate aftermath, and the replenishment of stocks and supplies to prewar levels.

Our projections, which incorporate extraordinarily conservative revenue estimates, see deficits peaking this year and heading back down thereafter. To hasten our return to balance, the President proposes to restore the system of spending controls under the recently-expired Budget Enforcement Act. He asks the Congress to pass, along with this year's Budget Resolution, a reenacted BEA incorporating two years of caps limiting discretionary spending to the 4% path that would match government's growth to the growth of American family income. That renewed statute should also reinstate the so-called PAYGO system that limits the budgetary effect of entitlement spending and revenue measures.

Finally, no discussion of this or any future budget should take place without serious examination of the real fiscal danger facing our Republic. We will debate the right level of imbalance for this year and next, as we should. We will argue over the right amounts to be employed in defense reconstruction, or economic growth measures, or fighting the scourge of AIDS, as we must. But, from a financial standpoint, these are small matters compared to the looming, unfunded liabilities of our huge entitlement programs.

The unfunded promises of Social Security are some $5 trillion, more than the entire national debt outstanding. The figure for Medicare is even more staggering: its promises exceed its future receipts by more than $13 trillion, a figure more than triple the national debt and 40X times the deficit we will run this year. We cannot conceivably tax our way out of this dilemma. Only sustained economic growth, coupled with thoughtful reform of these programs, can secure to future generations the same degree of protection, or more, that seniors enjoy today.

This committee, and its counterpart in the other body, have the first and fundamental role in helping the President determine the nation's priorities. You also are the taxpayer's first line of defense against excess or misuse of the dollars which the government takes away from them. On behalf of the President, thank you for your service here and for your leadership in restoring an orderly, effective budget process during 2003.

Chairman NICKLES. Director Daniels, thank you very much.

A quick question. I notice your baseline without any changes has a deficit in 2003 of $264 billion. The Congressional Budget Office had a deficit projected, I believe, of $199 billion, so that you were significantly more pessimistic. You even put a $25 billion assumption that revenues would be lower than what your computers were telling you.

Would you care to explain to us that $60 billion difference and why you put the $25 billion plug in for reduction a in revenue? It looks to me that you are just making it worse, and P.R.-wise it might have been better if you took out your $25 billion reduction in 2003 estimate and $15 billion in 2004, you would be less than $300 billion in both years. You wouldn't be at record nominal deficits. I don't know why that was done. Would you care to explain that?

Mr. DANIELS. Well, we were trying for accuracy, Mr. Chairman. I don't doubt that optically it would have looked better. We are actually $55 billion below our friends at CBO in our revenue estimate. I hope we are wrong. I really do. I think we would all feel better if we saw revenues recovering, if we saw deficits substantially smaller than we are forecasting. We have been trying to learn as we go, and there has been a completely ahistorical phenomenon going on with revenue. The economy has been growing and revenues have fallen. This is not what we have seen before.

Typically, as the Committee knows, in the year after a recession—a recession pulls down receipts, and that is to be expected. Typically in the year after, there is a very sharp snapback. That did not happen, and we are still learning why. A lot of it clearly was in the capital gains area and other forms of income related to, I believe, the stock market bubble. That is the reason we made the adjustment. We have just been watching as the best models of the brightest people missed on the high side. So we have calculated the likely extent of that miss, if it continues, and made that adjustment.

I sure hope we are wrong. It is the most pessimistic report in the field. Until we——

Chairman NICKLES. It is or is not?

Mr. DANIELS. It is. Ours is, as far as I know. Until we see revenues coming back, as you might have expected from history, we are going to continue to be careful.

Chairman NICKLES. Well, I guess I better appreciate or understand it, but just for the information of our colleagues, estimates have been fairly on target—correct me if I am wrong—on outlays, both by OMB and by CBO, while the estimates by everybody, private sector, OMB, and CBO, have missed it on revenues. They have missed it for years, and missed it big time between 2001 and 2002. We had a 7-percent reduction in revenues, and that is a big part of our problem. You have taken a more pessimistic estimate of what revenues might be, and maybe it is more realistic. No one is going to accuse you of a rosy scenario.

Still, revenues are hard to guesstimate. There were trillions of dollars lost in the market over the last 2 or 3 years, beginning in March of 2000, and that flushes through the system, maybe affecting corporations' behaviors and so on, which impacts revenues, total receipts. I notice personal income tax was down $150 billion from the high; corporate income tax was down about—oh, a significant sum, I can't remember, $40-some billion.

Mr. DANIELS. Could I just show one thing, Mr. Chairman, to pursue that point a little bit?

Chairman NICKLES. Sure.

Mr. DANIELS. We also missed revenues wildly in the earlier years. As I said, no one saw the surplus coming. Now with the benefit of a few years of experience in looking back, we can see a pattern that, I think, points us to a common-sense answer.

On the green line—I asked our folks: What is the long-term trend of Federal revenue? Obviously it moves up and down with events, but it is surprisingly stable, and it is about 3.3 percent. We looked back 10 years, 20 years, I think 40 years, and that is the average, and that is what the green line reflects.

Well, we hit an incredible hot streak in the late 1990's, and revenues surged far above that historical trend line. Where I think all predictors were misled was to imagine that that rate might slow down, but that we would move on from that top plateau. So the predictions that Senator Conrad was talking about assumed that we might grow at a modest rate but not drop, as we did.

What has happened, as you can see, is we sort of had a bulge of revenue, and now we have given it all back. In fact, we are just going to back to that long-term trend line, we think, in another year or two.

So it was a unique phenomenon, both on the way up and the way down, and I think now we can see the reason for the extent of the misses of both the surplus and its disappearance.

Chairman NICKLES. I appreciate your comments.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Director Daniels, as I listen to you, tax cuts seem to have played no role in the disappearance of the surplus. Our analysis would indicate it played the biggest role. When you look at what has already occurred, what the President has proposed going forward, the tax cuts are the biggest reason.

I want to go back to this question of estimating because, you know, I must have showed this fan chart that CBO was warning us at the time of the uncertainty of the forecast. I must have shown it a dozen times in this committee, I must have shown it dozens of times on the floor, warning people that the tax cut was unaffordable because there was a risk the 10-year forecast would never come true.

You told us not to worry, there is going to be more money than the forecast.

Well, as we can see now, there is not only less money than the—this is the mid-range of the forecast. That is what people adopted. As it has turned out in the real world, we are below the bottom range of possible outcomes.

I just have to say, in terms of holding people accountable, you all took what Senator Baker talked about in the 1981 tax cut as a riverboat gamble. You took a riverboat gamble. You said there was going to be more money or at least as much. It was wrong. It was wrong. It was a mistake. It was a huge mistake. There are enormous consequences associated.

Now what you are telling us is let's have some more tax cuts. Even though none of this adds up now, let's have some more tax cuts. This black line is the CBO baseline. The blue line shows what happens if you add the President's additional tax cuts. The red line is if you add the President's additional policies. We never get out of deficit.

Let's go to the final, which is from the President's own document. It shows we never get out of deficit and that in many ways we are in the best of the circumstances right now. We are in the sweet spot because the trust funds are throwing off hundreds of billions of dollars of surpluses.

My question to you is: Do you ever see us escaping from deficit if the President's plan is adopted? When would it be?

Mr. DANIELS. Well, quite possibly, sir. Let me take apart things you said piece by piece.

First of all, those fan charts are important. I showed them, too. In the 2001 submission, in fact, you and I agreed that it was a very difficult business trying to pretend we could peer out as far as 6 and 8 and 10 years when we made such enormous—had such enormous surprises just in the previous few years. We reserved 15 percent of the theoretical surplus at that time as a buffer against surprise. It wasn't near enough, as it turns out.

Second, it simply is not true that any policy, let alone the tax cuts, is responsible. As I just showed you——

Senator CONRAD. The tax cuts have no part of the deficits going forward?

Mr. DANIELS. That is not what you said, and that is not what I said. The deficit we see today would be a triple-digit deficit, would be $170 billion this year if——

Senator CONRAD. I am not talking about just this year, sir. I mean, let's be fair. I am talking about the 10 years of this budget window; the tax cuts and burgeoning debt. That is undeniable. That is a fact.

Mr. DANIELS. Well, sir, your comment moves me to use a four-letter word: bunk.

Senator CONRAD. The tax cuts have no part in the increase of deficits over the 10 years of this budget window?

Mr. DANIELS. The only deficit we know about is the deficit we are experiencing right now, perhaps the deficit for next year. Let's be a little humble about what we can and cannot see going forward. That same fan chart, which we don't prepare—our friends at CBO do—if you look at it now shows a range—I don't know, did we bring it?—shows a range from deficits larger than we proposed, but also including surpluses once again. The point is we——

Senator CONRAD. In fairness, that is without—that is without, as you know, any policy changes. That is without the President's proposed additional tax cuts. That is without the President's additional spending proposals. That is without any cost of war. That is without any policy changes.

The document from your own budget document shows we don't ever get out of deficit here.

Mr. DANIELS. Well, fortunately for me, my eyes are good enough to see that that chart goes to 2050. Now, having—I would think——

Senator CONRAD. It is your document, sir.

Mr. DANIELS. I know, but I am certainly not citing it as gospel the way you are. I would think having learned how much we can be surprised in either direction over the space of 2 or 3 years, you would be a little bit humble about telling us what is going to happen in 50.

Now, the point I am making is it is sometimes loosely said that we are in deficit because of the President's tax relief. That is not true, not close. As you know, and as some observed at the time, the President's 2001 tax relief bill has most of its effects over time. So if it is such a bad idea, you know, please stop complaining about it and propose its repeal.

Now, when you do, you will have a little trouble because you will have to explain to America what you want to repeal. Most of the money is in the lower bracket, from 15 percent to 10, that reduction, and in the child credit and in the marriage penalty. The pieces that, again, get loosely thrown around in rhetoric about the rates don't move the needle detectably.

It is an honest argument we can have that as to the future has nothing to do with the fact that recession, war, and a disappearing bubble put us in the red as we are today.

Senator CONRAD. I would just say to you it is absurd to sit there and suggest the tax cuts already enacted and the additional $1.8 trillion of tax reduction the President proposes plays no role in a return to massive deficits and dramatically escalating debt. That doesn't pass the laugh test.

Chairman NICKLES. Senator Conrad, thank you very much.

For the information of all of our colleagues, we are trying to stay on 5 minutes, 5 or 6. I am not going to ring somebody down unless it is necessary, but hopefully we will stay pretty close to that.

Senator Allard.

Senator ALLARD. Mr. Chairman, thank you.

I just feel like I want to respond a little bit to some of my colleague's criticism here and kind of put this in the proper perspective. Some of the comments that we saw put on the chart I noted were comments that were made before 9/11. Nobody would have predicted that. The stock market, nobody would have predicted that. I think that the Chairman of this committee hit it right on the nose about the real flexibility, the real problem we have had is on revenue.

So I think the question that is facing the Congress and facing this committee is how is it that we can best grow the economy. I look at what the tax burden is today to individual taxpayers as a percent of gross domestic product. If we look at the time between World War II and now, it is among the highest it has ever been. It is not the highest year, but it is among the highest years that it has ever been, and the most highest years have been in the last 3 or 4 years.

If we look at spending, like I think Phil Gramm said last year during budgeting, you know, we have been spending around here like a drunken sailor, and spending has gone up, and there has been tremendous increases in spending. We look at the corporate tax burden which in some cases may get us up to 60 percent, which is the second highest in the world of all countries when you do a comparison of all the countries. So I try and sit here as a policymaker and say how is it that we can stimulate this economy. You know, if it was increased spending, we should have been seeing it happen. The only area that I see where we may be able to help this economy is to reduce the burden of taxes.

If we look historically, the tax cut that we had a year and a half ago was passed by this Congress—almost 2 years now—that did help the economy. Even the Washington Post said in one of the editorials back in September, you know, we have to admit that if that tax cut had not occurred, we would have been in worse shape today, and so that it did help sustain the economy.

So I just want to emphasize that I for one think that if we are going to get this economy to grow, we are going to have to drop taxes to do it. It is the only alternative. Nothing else is working. We have got to do it, and I want to commend the President for doing it.

I would like to have you maybe share with me, Mr. Daniels, some of the thought about how the tax cuts that are being proposed now by the President are going to act to stimulate the economy and why you selected those various aspects of our Tax Code to stimulate economic growth.

Mr. DANIELS. Sure, Senator. I think this really points us to maybe the single most important issue that we all ought to try to join together and wrestle with. I think by far the most—the one the President spent the most time on in the time leading up to the submission of the program this week, in other words, his determination and the course of defense rebuilding and fighting the war on terror and homeland security was pretty much clear and understood. The big question was whether or not to act, try to act further to strengthen the economy. Senator Conrad, I think his questions really mean to go to this point. We know why we have fallen out of balance. The question is how best to get back in and at what pace. How urgent is that compared to some other priorities?

As we have been saying all week, a balanced budget is a very high priority for this President. There are a couple things that he has placed ahead of it. There honest people can differ.

So there was some considerable counsel during the last quarter of the year that says, look, the economy is growing, it won't be necessary to try to act further, and trust to luck. The President, after taking all that in, decided to act and in a way that most people found pretty bold.

He was not prepared to trust to luck that the economy would grow or grow more quickly or generate more jobs than it is generating. As I say, honest people can differ.

The deficit for 2004 would be well over a third smaller if you made that decision, and perhaps some Senators would prefer that, to opt for a much smaller deficit, hoping that the economy will perform adequately. The President came out in a different place. There we can have, and should have, really, a good discussion.

In terms of the pieces of the program, I think it is a balanced program for the near term. The acceleration of the rates, which in particular would have benefit along with the other provision on expensing for small business, I believe—I personally believe would have the most jobs effect in the short term. Behind that, the acceleration particularly of the child credit, which would put cash in the hands of families, principally low- and middle-income families, might have a near-term effect also.

The much debated dividend exclusion, the ending of double taxation of dividends, I would say is more of an intermediate and longer-term effect, but also very important. We don't need growth just next year to move back toward balance. We need sustained growth over a period of years, and a balanced program would try to encourage that.

Chairman NICKLES. Senator Allard, thank you very much.

Senator Hollings.

Senator HOLLINGS. Director Daniels, the budget deficit for 2004 is projected to be, what, 307 is what you project it to be?

Mr. DANIELS. Yes, sir.

Senator HOLLINGS. Well, now, you told Chairman Nickles a minute ago that you were trying for accuracy, and you and I have corresponded about this. If you turn to page 312, you will see without Social Security it is 482. Isn't that more accurate than 307?

Mr. DANIELS. Both are accurate numbers, sir. It is two different ways of looking at the question.

Senator HOLLINGS. Well, the law is Section 13-301 that was passed in this Budget Committee by a vote of 20-1 and passed on the floor of the Senate by a vote of 98-2 and signed by George Herbert Walker Bush on November 5, 1990, that you are forbidden to set a budget using Social Security Trust Funds. Isn't that correct?

Mr. DANIELS. Well, we report the so-called on-budget number faithfully for that reason.

Senator HOLLINGS. I know what you do. The law is there, and you are not supposed to do it. Yet you tell Chairman Nickles you are trying for accuracy.

Now, let's get really accurate and turn to page 332, and you will see that the debt goes up from 2003 $6.7 trillion to $7.3 trillion in 2004 for a deficit of $569 billion, not 307. That is the actual deficit. That is how much money comes in and how much money goes out. You've got less coming in, more going out. Just like any housewife keeps her budget. You're spending in the next fiscal year, according to your budget, the next fiscal year, $560 billion more than you take in. Is that correct?

Mr. DANIELS. Well, not in a cash sense.

Senator HOLLINGS. What is that?

Mr. DANIELS. No, not in a cash sense. The unified budget would actually be the right measure of that, the——

Senator HOLLINGS. I am looking at the arithmetic. Don't give me the unified and the fancy talk and dance now. Let's get to the truth. You said you were trying to be accurate. Where is my question inaccurate?

Mr. DANIELS. It is an accurate measure of the so-called on-budget deficit, and as you know——

Senator HOLLINGS. No, don't give me on-budget deficit. What is the debt? Doesn't the debt go up, which is the deficit, in my opinion, the gross—you have got it cited here, gross Federal debt.

Mr. DANIELS. Yes.

Senator HOLLINGS. That is what I am asking about, not the on-budget deficit.

Mr. DANIELS. Debt by either measure goes up, that is correct.

Senator HOLLINGS. We finally got that.

Now, you said the 307 is 2.7 percent of the GDP, but actually it is $569 billion, that is 5 percent of the gross domestic product. Isn't that correct?

Mr. DANIELS. That would be about right.

Senator HOLLINGS. Now, that would be about right.

Now let's turn to page 1 of this budget here, and I will read you a sentence here. It says, "Compared to the overall Federal budget and the $10.5 trillion national economy, our budget gap or deficit is small by historical standards." Do you remember writing that?

Mr. DANIELS. I do.

Senator HOLLINGS. So that is exactly what Kenneth Lay was doing with Enron, making his budget appear to be more favorable to the stockholders. Here what we are trying to do is make our budget look better for the taxpayers, because you read this here on page 1, "Compared to the overall Federal budget," and everything else, "the deficit is small by historical standards." Whereas, the truth is—you finally acknowledge it on page 332—that it is $569 billion.

Do you know, Director Daniels, that if you took all the deficits from Harry Truman in 1945 to Gerald Ford in 1975, 30 years, the cost of World War II, the Korean War, the Vietnam War, and you added up all of those deficits for six Presidents in 30 years, it would only come up to $358 billion. Here you are submitting a budget with a deficit of $569 billion and calling it historically small?

The truth of it is, look at your page—go to this other book, historical tables, talking about the history, and you will see on page 117 that the debt as a percent of GDP goes to 64.8 percent.

Now, in the Maastricht Treaty in the European Union, you can't even become a member unless your debt is 60 percent or less of your GDP. Here you and I, the United States of America, which is mouthing around about Germany and France being cowardly, they could come back and say you and I are cheapskates. We won't pay the bill. That is why all the economists in all the countries believe paying the debt and paying the bills and not having excessive borrowing. That is why they have got it in their treaty. Here you have got 64.8 percent, and you would have to go back to 1955, almost 50 years, historically, to find that level.

Director Daniels, I just can't understand why we don't get the truth about this budget and start paying for the war. While you are testifying, I can tell you now we are not going to be on TV because everybody wants to hear Colin Powell. They don't want to hear you and me right now. [Laughter.]

Senator HOLLINGS. That is fortunate for both of us. What happens is that he is trying to sell the United Nations on going to war, and we as the Budget Committee ought to be trying to sell the country on paying for the war. We paid for the war in every war. Even in the Civil War, President Lincoln raised taxes. Tax dividends rather than cut taxes. Raise the income tax rather than cut taxes. You can go right on down. We had a 90 percent personal level in World War II, in Korea, and you come historically the corporate level, Mr. Chairman, at 50 percent, and what we are telling those poor GIs, we want you to go into Iraq—we are waving the flag. We are loyal. We are supporting you. We hope you don't get killed. Hurry back because we want to give you the bill, we are not going to pay for it. Me and my crowd, Strom and I are home free, and we are going to give it to the poor GI going into Iraq.

Now, this is the first sad Congress that ought to be ashamed of themselves and a Budget Committee that dances around the fire about charts and everything else. Do you believe we ought to pay for the war?

Mr. DANIELS. Well, Senator, I believe you have framed this question in the right way this morning, as you often do. I would like to respond, I would like to start responding by saying that I think you are presenting the right question. You said there is a risk in excessive borrowing, and I think everyone would agree. The question is: What is excessive? Let me present the issues as the President faced them.

Senator HOLLINGS. While they are looking for that, he said we have enough stimulus. You say you have got—this year you project on that same page, the last page, that we will have a $554 billion deficit, Mr. Chairman, $554 billion at the end of September this year, without the cost of Iraq, because we haven't gone in yet, 554, and next year 569. That is a trillion stimulus, gentlemen, ladies. That is a trillion stimulus. Senator Daschle's is 146 and the President is 133, $12 billion more a month does not stimulate. I mean, we have got enough stimulus. In the 2-year period, we have got a trillion dollar stimulus going on, and running around here trying to buy the election is really what it is, not the needs of the country but the needs of the campaign.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Hollings, I am going to have to put you in the undecided category as well. [Laughter.]

Chairman NICKLES. I am counting votes around the table.

Director Daniels, do you want to make a comment?

Mr. DANIELS. I don't feel I gave a complete answer to the Senator's question, and let's do talk common sense and not numbers that would be hard for folks to follow.

You cautioned against—and the President would agree—excessive borrowing. The problem with governing is you have to make choices based on the situation as you find it. We find ourselves, of course, in a situation no one could have imagined for two or three different reasons just 2 years ago. This is the way it looks to the President, and I know it may well look different to you. You recognize what a baseline is, and our baseline—and CBO's actually says just the same thing—tells us that if the central goal, if our No. 1 priority should be to get back to balance, it is not hard to do. We could hold the Government at exactly the position it is today. We could grow it with inflation, and you would be back in balance in a couple of years.

The question is: What would you not do? What would you have the President not do? Would you not try to grow the economy? Most members of both parties—there are a lot of differences about how best to do it, but most folks with whom I have visited believe we ought to act, not trust to luck.

Would you not further strengthen our defenses and our homeland defenses and prosecute the war on terror? Would you not begin the drive to improve and modernize Medicare? Would you not continue doing something more—the President will be criticized for not doing enough more, I am sure—about education of disadvantaged children, about veterans, about global AIDS and so forth? That is the debate we ought to have.

If, in fact, the wisest thing we can do as a country above and beyond those other objectives is to get back to balance, we can do that. It is not impossible. I urged your colleague a minute ago not to give up so easily.

These are the President's choices. Apples to apples, the deficit we will face is about average for the last 25 years, counting the surplus years. It is not extraordinary. We ought to try to move it back toward balance, and the budget forecasts that happening. You can make it much closer to balance right away if you are prepared to forego some of these initiatives, and that is what the budget resolution is all about.

Chairman NICKLES. Thank you very much.

Senator Crapo.

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

Mr. Daniels, if you could leave that chart up for just a minute, I would like to talk with you a little bit more about that.[2]

I think that the debate that we are having, that we see being framed, misses the point to a certain extent. That is, it seems to me that a lot of the discussion, both in the media as well as here in the halls of Congress, circles around whether we should try to balance the budget now—in other words, to reduce the deficit as much as possible—or whether we should have tax relief as an effort to try to stimulate the economy. The attack that I seem to hear is one that says we can't have tax relief now because it would cause us to have too much in terms of deficit.

I am remembering back to when we were debating President Clinton's proposals for tax increases, and we had the same kind of debate in reverse. We can't have a tax increase now because it will—actually it was framed in the context of those of us opposed it saying we can't have a tax increase now because it will stimulate more spending, not help us reduce the deficit. In those days, we were showing figures that for every $1 of tax increase that we had had under previous proposals, spending in Washington went up by $1.50 or something like that. The question we tried to focus on then, which is the question I think we should focus on now, is spending and whether that spending is justified and whether tax relief, which is a form of spending of the Federal revenue, is justified in terms of stimulating the economy.

Here is the point that I wanted to focus on. It seems to me that you have hit the nail on the head by the chart that you put up here. For those that are criticizing the current deficit—and, frankly, I am one of those who thinks that maybe we can do a better job at reducing the deficit as we put this budget together. For those

[2] No chart provided at press time.

who are criticizing the deficit that the President has proposed in his budget, they have to be ready to say what it is that they would do differently.

Now, some have said let's not do the tax cut, and that is where I see most of the focus of the debate today. If you look at your chart, and if you look at the statistics that have been presented, just focusing this on the tax cut doesn't get to the issue.

We just went through a debate and a series of votes on the floor in putting together last year's final appropriations budget where we had proposals to spend somewhere between $400 and $500 billion more than we ended up with ultimately in the budget that we put together.

So you and I both know that there are those who want to spend a lot more in every one of these categories and others if they have the opportunity.

Again, that is the debate we ought to be having. Should we block all spending now and have a freeze and not do what we need to do for national defense, not do what we need to do to prosecute the war on terrorism, not do what we need to do in order to protect our homeland security, and not do the things that have been talked about here, and not have an economic stimulus package in the form of tax relief? Or should we have a different mixture of the entire package?

The question I asked you is maybe just to elaborate a little bit further on the points that you were just making. We all want to reduce the deficit, and I for one don't think that it feels totally satisfactory to say that it is small in terms of historical circumstances. That is true. Frankly, I would like to see the deficit be zero. You would, too.

What is going to be the impact on the deficit if we don't have the tax relief but we do then go back into the spending mode that we just fought off in the last few weeks here in the Senate?

Mr. DANIELS. Well, Senator, the irony is not lost on me that there are people in town I bump into on Monday, Wednesday, Friday who are urging a lot more spending, and when I see them on Tuesday, Thursday, and Saturday they are yelling at me about the deficit. You know, you can't have it both ways.

Clearly, spending restraint, I would hope there would be bipartisan support from those who share the President's priorities and from those who believe that a balanced budget should come ahead of some of his top priorities, even higher on the list. I would hope there would be bipartisan agreement, for goodness' sake, let's control spending on the way. The President suggested a common-sense measure and a moderate 4-percent growth, which is a substantial deceleration from what we are really forced to propose, more like 9 percent in the year just past.

Senator CRAPO. Could I interrupt and just ask you a quick—I know our time is running out here. Would you agree, then, that for those who are saying that we don't do the job properly with regard to the deficit in the current President's proposal, that first and foremost they need to say what it is that they would not do that would help bring that deficit down? If that is they would like to stop the tax relief, they need to recognize what impact that will and won't have on the deficit, and make a commitment that they won't replace that loss of proposed tax relief with increased spending. Would you agree that those are the—that those who are making this argument would have to at least answer those questions?

Mr. DANIELS. Well, I am hoping that will happen. You know, the old question "Where's the beef?" came to my mind this morning because sometimes in these forums beef is all we get—people beefing about the situation we are in, but not willing to step forward and present an alternative plan.

I want to say a word of appreciation for Senator Hollings, as I have often felt moved to do. First of all, he has drawn our attention back again to the long-term fiscal problem we have, the unfunded liabilities, the true liabilities on the books of the Federal Government, which are much bigger than any 1-year or 2-year or 5-year deficit we are looking at. Second, he puts squarely the question: Might it be wiser to raise taxes in the situation we are in? I don't mean to put a proposal in his mouth, but he at least raised the question. That is an honest question.

Now, the President came out in a different place. He came out that, as perhaps your question suggested, believing that higher taxes on a weak economy might be very counterproductive, might even turn us back in a negative direction in terms of economic growth. He would prefer to move in the direction of growth and stimulus, even at the cost of a somewhat higher deficit temporarily. That is an honest thing we ought to be debating, but it is incumbent on those who want to throw rocks at his priorities to tell us what theirs are.

Senator CRAPO. Well, it just seems to me that whether the proposal is to increase taxes or to not have a tax reduction, that those who are weighing in on any of those proposals or something in between need to be prepared to also commit, if the issue is the deficit, that the increased tax revenue or the savings of tax revenue lost through stopping a tax cut would be dedicated to the deficit, not to increased spending.

Chairman NICKLES. Senator Crapo, thank you very much.

Senator Murray.

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

Mr. Daniels, I really don't envy you your job of trying to sell to the American people the fact that long-term debt and deficit spending is a good idea. I came to the Senate in 1992, and I clearly remember Ross Perot running around the country with charts and graphs and making a very clear case of why deficit spending wasn't good, and as a result of that, my coming to the Senate, a number of other people, and we put together some really tough package back in 1993 that got us out of that cycle. I think the American public is pretty cynical about deficit spending.

I come from a State and a region, as Senator Wyden knows, where we have been struggling for the last 2 years. I sat on this committee 2 years ago when the Administration was projecting a $5.6 trillion surplus in 10 years, and I cautioned everyone to be careful. Oregon, Washington, other States on the west coast were hit with a huge energy crisis. We saw a real impact on our employment. The dotcom bubble had burst. I told this committee that surplus is going to be gone soon. I, of course, wasn't able to predict 9/11. That had a serious impact on it, too. I was very concerned about a tax cut at that time because we saw on the west coast the unemployment rising. That has not left us. Oregon and Washington are still at the top of the country in terms of unemployment. We have had 76,000 people in my State lose their jobs in the last couple of years. One out of nine people don't have health care today because our health care system is based on employment. They have lost their health care as well.

We are very concerned about the budget proposal that has come forward to us, the tax cut proposal that could put us into a worse deficit spending; but even more so, people are saying, What does this do to help me get back to work?

Now, I have two quick questions for you.

How will this tax proposal put people back to work in my State today? I don't see how a dividend tax is going to help the unemployment rate on the west coast?

Second, I would say in response to my colleague from Idaho, who I share a lot of concerns with as well, sometimes spending is important to get us back on track. When you put money into transportation and you build highways, you put those people back to work immediately at construction jobs and engineer jobs and design jobs, and that helps our unemployment. It helps economic development in the long run.

So is it correct to say that spending is always not helpful to our economy? I don't think so, and I would love to hear your response to both of those.

Mr. DANIELS. Well, thank you, Senator. Your cautions a couple years ago were well placed, and we now see how they were well founded. The President shared them, but events overtook us all in a way that maybe not even you had foreseen.

In terms of the growth package, I think I would stand on the answer I gave a few minutes ago. I think in terms of immediate help to put people back to work, I would sort of rank the—I would rank the proposals roughly this way: I think the acceleration of the rates, probably first, both for the benefit to consumers but also because so many small businesses would see a fast improvement in their situation and might be able to hire more people. You know that that is where the jobs come from, net new jobs in this economy. I think behind that the child credit, through which many of your constituents would receive an immediate several hundred dollars, depending on their family circumstance, from bringing that reform that Congress has already voted for forward. I think the small business is expensing up there at the top, too.

One other thing I would mention that I think has gotten too little attention is the President's proposal, on top of the unemployment insurance compensation that we have now for, $3-plus billion for new re-employment accounts, in which 1.2 million Americans, including many of your constituents, could access money that they could control to suit their own personal family circumstance and to create an incentive, because they could keep the balance if they got back to work more quickly. It is a new idea that we hope——

Senator MURRAY. Well, I would agree with you. You are talking about putting cash in people's pockets today. That is important if you want them to be purchasing things. I think that the other side of that is if this puts us into debt, it is going to cost people more, as Ross Perot told us so many times, in terms of their interest rates on their mortgage or their house or sending their kid to college.

Mr. DANIELS. This is what governing is about, Senator. The President believes it is a good idea, it is a good chance to take to take an additional step for growth at this time.

Again, there was a lot of counsel—there is still some out there—that says don't take that step, things well enough—leave well enough alone. That wasn't where he came out.

With regard to interest rates, interest on mortgage rates, we have the lowest rates in 40 years, thank goodness. It has been very beneficial to individuals and to the economy. We want to keep an eye on that, but for the moment that is a big plus.

Senator MURRAY. Well, on the spending side, don't you agree that when you spend money, for example, on transportation projects that I alluded to, that also helps get our economy going again, gets the revenue streams going again, and moves us in the right direction?

Mr. DANIELS. Well, the President is proposing, for example, greater highway spending in a new reauthorized highway bill, and that certainly I think has done well. Better infrastructure is very good for the economy. When I think of highways, I think first of all of the way they enable businesses and individuals to practice more commerce. We need a good infrastructure to do that.

I think we have to be a little cautious about and always remember that the dollar we spend on a given project had to be taken from somebody first.

Senator MURRAY. Let me ask—is my time up? A really fast, quick question. Our State legislatures are in extreme—they have to balance their budgets. We have a $2.5 billion deficit in the State of Washington alone, and I am concerned about the Medicaid reform package. If you could just comment quickly, it looks like a block grant proposal that has failed several times in the past, and I just am curious on whether or not—how this is going to help our States when it seems to me that combining these programs is not going to help our State legislatures when they are dealing with the Medicaid crisis.

Mr. DANIELS. The first thing to note is it is purely optional, so any State that believes it would not be of net benefit to them can continue on without any effect. It involves—if you get a chance to look at it more closely, it involves what States, almost all States, I think, have been telling Secretary Thompson and telling the President they want, much more flexibility and more money to go with it, several billion dollars in the first few years, so there would be more money per beneficiary, along with more flexibility.

Again, it is strictly up to the States to choose.

Senator MURRAY. I know my time is up, but let me just say that if you base it on the formulas from the past that have rewarded States who are not as efficient, it is simply going to put more of our State legislatures in a bind. I will talk with you more about that.

Chairman NICKLES. Senator Murray, thank you very much.

Senator Ensign.

Senator ENSIGN. Thank you, Mr. Chairman.

I want to take a little off of what Senator Crapo and Senator Hollings were talking about. I do think it is very important for us to look at the long-term debt that we have with Social Security. As a matter of fact, Senator Hollings, I am one of those people that would love to see Social Security money not touched. There are a couple of reasons that I would like to protect Social Security one, we would have to reduce Federal spending. We would be forced to. The money wouldn't be there to spend. If we actually had to take that money and put it in an account, we would be forced to reduce Federal spending.

Second, as far as I am concerned, it would give us much more flexibility on saving Social Security for future generations and would give us the option of possibly creating private accounts for future generations, we could turn Social Security into a pension system. That is the way that Social Security should have been set up a long time ago. It wasn't. It was a pay-as-you-go type of system, unfortunately. I would like to see it someday transitioned more into a pension system similiar to what many companies have. If companies or States, borrowed money from their pension funds and spent that money, there would be a revolt in this country. So I would certainly echo those types of thoughts.

Taking off of what Senator Crapo said, though, I am critical of those in Congress who want to increase spending, but I am also critical of the Administration in this regard: I don't think enough emphasis has been put on the deficit. It is just a priority that I think should be higher on the list of the President's priorities. I think it is a legitimate discussion to have. There are choices that will have to be made. I feel it unfortunate that the President didn't lead a little more on saying, you know, we are going to war. We are in a war on terrorism already, and we are probably going to war with Iraq. I think most of us feel that if we are going to war in Iraq that it is going to be a significant cost, so we have to make very wise choices on this Budget.

I have made those kinds of votes in the past, and I would be willing to join you in those difficult choices. I think that that is up to Presidential leadership, for one, to help control spending, because without the President it is difficult to get enough votes to control Federal spending.

On your graph, if you could put that one graph up, I had one quick question on there. The Medicare part of the deficit, does that include prescription drugs?

Mr. DANIELS. Yes.

Senator ENSIGN. How much larger, if the bill that was sponsored by Senator Kennedy last year, if that bill would have passed, how much larger would those deficits be in the out-years?

Mr. DANIELS. Well, they would be substantially larger, but the real place to see the difference, I suspect, would be in capturing the unfunded promise that we already have. The unfunded promise of Medicare is about $13 trillion. That is more than 3 times the national debt, or 2 times if you measure the gross debt, as Senator Hollings does. As we try to improve Medicare and, after that, Social Security, we have to be very, very careful to watch that number.

The bill from last year that advanced the farthest in the Senate would have added another $6 trillion to the long-term unfunded liability of Medicare. So we do have to be very careful about that in any reform that we pass.

Senator ENSIGN. I agree, and I think that we have got to be careful as we go forward. I love the talk from both sides—especially from the other side of the aisle about deficits. I love the fact that they are stressing how important it is to control deficit spending. I just hope that when it comes down to votes, that we get the votes on some of these things because we know that there are going to be votes on spending more money on the Medicare prescription drug package.

Senator Hagel and I, we had the only package that fit within the $300 billion number that we had available to spend last year. Every other package was outside of that number, and some of them were substantially outside.

Another point that I would like to make is what Senator Crapo said, and I made this point last week, that the $500 billion in extra spending that we tried to tack on to the omnibus appropriations bill, that adds to the baseline, which, you know, adds tremendously to the deficits, does it not?

Mr. DANIELS. Absolutely.

Senator ENSIGN. So if we are going to be concerned about the tax cuts, those same people should be willing to not vote for more spending, I guess is the point to be made.

Mr. DANIELS. Well, again, it is a matter of where one's priorities are, and I will take back to the President your reservations. Likewise, I would agree with you that those who differ with this set of priorities do have that same responsibility to tell us what they are for.

Senator ENSIGN. Thank you, Mr. Chairman. Just two quick closing comments. That is, I criticized the other side of the aisle. Once again, I criticize the Administration. The steel imports last year was a terrible decision on the Administration's part—I think it hurts the economy, and adds to the deficit. Additionally, sigining the farm bill was also a terrible decision made by the Administration as it also adds to the deficit. So I am trying to be fair in my criticism here. If we are concerned about deficits, I would like to see us all working together. I personally believe that it is important for us to pay down long-term debt and to handle those unfunded liabilities that we have in the future with Medicare and Social Security.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Ensign, thank you very much.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Welcome to Mr. Daniels, and I think your point about what are you for is exactly what this is about. Senator Hatch and I, for example, have introduced the Health Care That Works for All Americans Act, the first comprehensive, bipartisan health proposal in a decade. That is really why I serve on this committee, is to try to find some common ground on health care issues.

Let's talk for a moment about the way the Administration is approaching this health area. It seems to me there are two special problems today. Medical costs are gobbling up everything in sight. The number of uninsured has increased dramatically, we have a demographic tsunami, millions of baby boomers retiring in 2010 and 2011.

So tell me, if you would, because I want to find common ground with the Administration—that is what Senator Hatch and I are pursuing with our proposal—how what you are looking at moves us in that direction. For example, the tax credits that you are offering for health insurance, I look at those and I don't see how we get very far down the road with the idea of the Administration's tax credit proposals if you can't buy decent coverage at an affordable price. So I ask, as somebody who wants to work with you, somebody who has got a bipartisan proposal in front of the Congress and the Administration, how is what you are looking at with tax credits going to sort of move us down the road given the seriousness of the problem?

Mr. DANIELS. You are correct that the President has proposed—re-proposed—for the third time tax credits to help those who are not insured to obtain coverage. It may not be a complete answer, but we think it would be of tremendous value to those who could take advantage of it.

I think other areas for early cooperation could be medical malpractice reform, clearly a major driver not only of costs but driving physicians out of medicine altogether right now in States where frivolous lawsuits have run amuck. Medicare reform we think is fundamental to overall health care reform.

I also encourage you to stay in close contact with Secretary Thompson, who very quietly but effectively has, through work with the States, through a much more flexible policy of waivers with the States, has enabled between 1 and 2 million Americans to secure coverage in the last year or two.

So you have put your finger on the biggest problems, the cost, the uninsured, and the long term, and the President is trying to move forward on all fronts.

Senator WYDEN. I am going to move on. I think Secretary Thompson's initiatives for demonstration projects is a good one. I have met with him. I am going to support his demonstration projects, and I say full steam ahead. However we have got to start looking at health care as an ecosystem. What goes on over here relates to what happens over there. I hope that you all, particularly at OMB, will look at this proposal that Orrin Hatch and I have. We have gotten a favorable reaction from the AFL-CIO and the Chamber of Commerce, two groups that don't exactly flock to each other on this health issue. We are offering an alternative. We would like your support.

The second area very briefly, Mr. Chairman, involves a regional matter that has my part of the country up in arms this morning, and that is your proposal with Bonneville Power. The proposal there, particularly in the performance assessment section, seems to indicate that OMB is looking at trying to privatize major functions of the Bonneville Power Administration. We just think that would be poison for our area, and I would like to give you a chance this morning to take that off the table if that is the position of the Administration. This is something Democrats and Republicans look at in a bipartisan kind of way. Tell us what your position is with respect to the Administration's desire to privatize functions at Bonneville Power.

Mr. DANIELS. Well, no such interest on our part, if you mean by that the privatization of the entire authority out there. Questions have been raised for a long time in this administration, the last administration, and Presidencies before that about the operations there, about the fairness of it, really, to taxpayers nationwide. No, it is—improvements are in order, but not what you call privatization.

Senator WYDEN. Well, I appreciate that. Just know that just yesterday Bonneville Power said this is something the Administration believes should be explored. So people out in the region are corcerned, particularly, given how hard we have been hit economically across the board. There is enormous concern in the Northwest about this and when OMB says critical things about Bonneville with respect to the private sector, and it sure looks—if it looks like a dog and acts like a dog, sometimes you think it is a dog. This seems to indicate support for privatization. You have told me that you are not interested in doing that. Know that our region feels very strongly about it, and I thank you.

Mr. DANIELS. Thank you.

Chairman NICKLES. Senator Wyden, thank you very much.

Senator Cornyn.

Senator CORNYN. Thank you, Mr. Chairman. I want to thank Director Daniels for being here today and tell you that I believe the President and OMB deserve a lot of credit for this budget that you have laid out. As you pointed out at the outset, this isn't about just numbers. This is about priorities. This is really about values, and I think you have done a good job of laying out what those values are, what those priorities should be, and challenging those who would criticize this budget to come up with some alternative.

I think we have heard some of those mentioned today that I personally would not support, like tax increases, but that is the debate we ought to be having, and I appreciate your work and your office's work.

I am particularly pleased to see that the Administration remains committed to restraining the growth of Federal spending, and I happen to have a different point of view from Senator Conrad, for example, on the effect of the tax cuts and believe that really the primary culprit for the situation we find ourselves in today is spending increases that range up to a 10.8-percent increase in the year 2000, but we have seen pretty much lack of any restraint whatsoever on the part of the Federal Government when it comes to spending money during good times, and now when our income and our revenue is dramatically decreased, as it was in 2002 with a 7-percent decrease in Federal revenue because of the circumstances you have summarized for us, it calls for restraint, I believe. I think the President's proposal of 4-percent growth—not a cut. You know, nowhere else I have ever been would somebody consider a reduction in growth a real cut except in Washington, D.C. The President's budget proposes a modest 4-percent growth in the Federal budget and spending restraints that would allow us to hopefully deal in a responsible fashion with the unfortunate set of circumstances we find ourselves confronted with today.

I really have just two questions I want to ask. I am very supportive of the President's plans to improve government performance and make it more accountable to the public when it comes to how tax dollars are actually spent by the Federal Government by reducing waste and inefficiency and making sure that taxpayers really get a bang for their buck. Could you summarize just briefly for us here what does this year's evaluation reveal about the performance of the Federal Government when it comes to spending tax dollars in a responsible way and being accountable to the public we all serve?

Mr. DANIELS. Yes, Senator. There is a new document in the budget this year, Performance and Management Assessments, and the bulk of that document does report the assessment using a standard evaluation tool that was worked out by people throughout the Government but with the help of outside experts of 234 programs. It is a long step, but it is really just the first step toward a goal that many Members of Congress have urged on OMB for a long, long time, and that is to get serious about identifying what works and what doesn't so that Congress can make budget decisions with that in mind. We don't want to overclaim for this, but people have worked very, very hard. It is the first serious attempt to do this, and I think there are some lessons in it.

There are very few programs that we can identify as clearly effective. The test of effectiveness includes things like a clear purpose, the accountability to devise measures for telling whether that purpose is being approached or not, and then hard results using those measures. There aren't very many programs that meet that test right now. There are a fair number of programs that clearly fail it, and then the top of the bell curve there is a large number of programs about which we just don't have enough information.

As we see it, that is not a gentleman's C. That is an F in waiting because the burden of proof must finally be on the proponent of spending. So a program that goes on year after year and can't prove its value at some stage ought to give way to something that we think might work better.

I appreciate your question, and I do hope that people will spend some time looking at the evaluations and giving us feedback. Undoubtedly, of the 234, some are in error or missing some important information. It is a very impartial attempt. There is no ideology in it. There is no question in that assessment tool about should Government be doing this or not. That is a separate, of course, very important question, but this is meant to be ideology-free. We are just trying to get at the issue of does it work or doesn't it, can it prove it works. We would very much value feedback, and we are beginning to get some.

Senator CORNYN. I appreciate the Administration's effort to begin to provide that information to the Congress so we can then make some decisions based upon the information that you are providing us.

My second and last question has to do with the new Department of Homeland Security. I, like a lot of other Americans, have wondered that with the consolidation really of homeland security functions from 22 different Federal agencies into one Federal Department of Homeland Security whether we are going to see some savings associated with that, perhaps through increased efficiency or just consolidation of duplicative functions, or if we have not and do not see any in the short term, whether you contemplate that we will in the mid- to long term.

Mr. DANIELS. Well, Senator, the motivation for that Department was not to save money. In fact, we are going to spend more money. On a percentage basis, it is the highest priority in the President's budget. This President will do and spend what it takes to protect Americans.

As I said earlier, we don't count it in those numbers, but I consider the most important homeland security money we spend to be that the military and intelligence services use to go after terror before it ever shows its face at an American airport or other point of vulnerability.

In the immediate term, there are enormous responsibilities on Governor Ridge, Secretary Ridge, and his people to get organized. Thank goodness the Congress passed that legislation. We clearly were not organized. It's no one's fault but we never needed to be able before to identify and assess and protect against this sort of threat. So that was a fundamental first step, but the first real job is to get organized and to get better at this as fast as we possibly can, "this" being protection of our most vulnerable places.

Along the line, of course, we would expect to see some savings from consolidation. Shame on all involved if that doesn't happen. That is not the first motivator.

Also, there are some limitations on what the Department can do for the first year in terms of personnel and so forth, and that will delay the day when I think meaningful efficiencies can occur. Keep asking the question because it is an important responsibility.

Senator CORNYN. Thank you very much.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Cornyn, thank you very much.

Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman, and thank you, Mr. Daniels. I know you are in a lonely fight sometimes to contain spending. I salute you for that. I remember very distinctly being elected Attorney General of Alabama in 1994, and my predecessor, through colossal mismanagement, had left us with a $5 million deficit looming on a $15 million budget. That is a big deal. Faced with no alternative, we identified the non-career civil servant employees, and we had to let them go, one-third of the office. As we reorganized and closed offsites and got rid of automobiles and did other things, we made that office more productive than it was before I took over. It still well below the number.

So I think you are correct, and I hope you will continue to challenge these agencies and departments to reduce their overhead, make themselves more productive and efficient. Your program—what is it called, PART?—to identify those is a step in the right direction. I think you can be a lot more aggressive in my view. I don't think most people know that in this Government and in this Senate you walk around here and see the money we spend and say we can't save on efficiency. That is not correct.

So what do we expect the inflation—I know our spending is going up 4.2 percent this year. What do we expect our inflation rate to be this year? Do you have that number.

Mr. DANIELS. 2.2.

Senator SESSIONS. So this is nearly double, spending is going to go up nearly double the inflation rate. I know the Chairman asked to try to work together in a bipartisan way, but I don't think we can forget that on a virtual party line vote just a few weeks ago, amendment after amendment after amendment came from the other side on issues all of us cared about to spend more, more, more. They totaled up to $500 billion more in amendments just to those appropriations bills and didn't pretend to deal with every issue. We have people here that want more roads and more health care.

So ultimately we need to understand that this Congress can't solve every problem in America. Yes, it sounds good politically to say I am going to do more and more and more and spend more, but if we don't maintain our discipline, we are going to be in trouble. I think Senator Frist deserves a lot of credit for saying we are going to have a reasonable increase in spending this year, but we are not going to go with another $500 billion.

The testimony we had yesterday from Dr. Hubbard was that we would have with the President's growth package a 9.9-percent, almost 1-percent increase in GDP this year in growth, and another 1.7 next year, and we would create 1 million more jobs. So isn't it true that if that were to occur, based on the President's growth package, we would begin to see some increase in revenue as a result of those new jobs and growth?

Mr. DANIELS. Yes, sir, I think everyone that I know of agrees that there would be a recapture, a feedback, an effect from any measure that Congress might vote for, any growth measure. Economists will differ as to what percent of the money left in taxpayers' pockets or spent by the Government would come back. Of course, in our accounting we use zero because we don't pretend to know how to be precise about that. I guess Dr. Hubbard gave you an estimate of about 40 percent, I believe it was, of this particular growth package would come back.

I don't know if that is right or not, but it is on the order of the estimates a variety of outside economists gave as the President thought about this. So we know that the zero that we incorporate is wrong and too pessimistic, but we make no attempt to forecast just what that positive effect might be.

Senator SESSIONS. So you have no dynamic scoring, but it is obvious to me that if all economists agree that we will have some increase in growth as a result of this package, it will increase tax revenues to some degree. You are providing no—because of the dispute over dynamic scoring and the fact that nobody knows precisely how much, you are not showing any numbers for that.

Mr. DANIELS. That is right. As we said in answer to an earlier question, for now we have certainly the most pessimistic revenue numbers of any forecast I am aware of. We sure hope they are wrong, and we hope a growth package will make them wrong by a big margin. Unless and until we start to see that, we are going to continue to try to be cautious.

Senator SESSIONS. With regard to your PART program, this program to analyze the agencies of Government and to challenge them to be productive to meet the mission for which they were created to begin with, I would like to ask a couple of questions about it and would just say all of us know that one of the great failings of Government in this Congress and many times State government is that when agencies and departments cease to be productive and efficient and really be worthy of the money they get, we never seem to stop them. If anybody challenges them, whatever their mission is, they holler and say that, you know, we are hurting people unfairly. It is very, very, very difficult to stop them.

Your analysis showed that only 6 percent of the programs in Government were rated as effective, 24 percent were rated moderately effective, and 50 percent you weren't able to rate.

On those programs that turned out to be effective, what kind of increases in spending did they get? What kind of increases or cuts have you proposed for those that are ineffective?

Mr. DANIELS. Yes, there is a table in the book, Senator. It is not an exact one-to-one correspondence. In other words, there are some programs that are ineffective for which the right answer might be let's fix what is wrong, it is too essential not to do, or there is not an alternative program that gets at the same thing. In general, those that we were able to reach a clear judgment about, we reinforced with greater increases, and vice versa.

Let me make one other point. There are really two parts to that book: one that looks at individual programs, like your question pointed to; the rest looks at the departments and the way they are doing their day-to-day business. The President has made it a part of the responsibility of every Cabinet Secretary and Department head and people working for them to leave the everyday operations in better shape than we found them. This is often an afterthought or no thought at all for busy people who are eager to work on new policies and so forth. We have made quite a to-do of it, and I do believe a sense of real accountability and team spirit has set in around it.

Last, let me say that it is refreshing to get a question about productivity because it is too rarely asked, and in American business, business generally, productivity is an expectation. I think we all know one great thing happening in the economy is productivity continuing to run up above 5 percent.

Senator SESSIONS. Right now, even——

Mr. DANIELS. Right now. That means that a business becoming more productive at a 5-percent rate can deliver the same amount of work next year with 5 percent fewer dollars. What would it be like if the Federal Government was improving its productivity even by a percent or two?

Almost no department seems to think that way. There are some that are really working on that. I will cite them: the Veterans Administration, Social Security Administration, who are actively looking at places in their activities where they ought to be able to do more per person or per dollar invested and thereby give the taxpayer better service at fewer dollars.

Senator SESSIONS. Thank you.

Senator SESSIONS. Thank you, Senator Sessions.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, and, Mr. Daniels, thank you for coming. We all want to focus on increased productivity and efficiency for the precious dollars that are available.

I would focus on two things. First, in terms of economic models, I continue to feel the need to say to colleagues over and over again that we don't have to debate economic models. We have experience in our lifetime of models that have worked and not worked. We have the 1980's and we have the 1990's.

In the 1980's, there were supply side economic tax cuts that were put forward, very much like this administration, and with the hope that it would trickle down, with a massive buildup in spending, most of which was defense spending at that time. I lived through the 1980's as a State legislator in Michigan and lived through the highest unemployment, at least in my lifetime, and explosion in interest rates as a result of a massive buildup in debt. That is one model.

We come to the 1990's, and I had the opportunity in the mid-1990's, 1997, in fact, to be in the Congress in the House when, for the first time in 30 years, we balanced the budget. We had a different approach. We had a focus on fiscal responsibility, paying down the debt, and more focus on demand-side tax cuts for the middle class, an actual slowing in spending, contrary to what is often said, a slowing in spending. I was there for the voting on cuts in spending at that particular time.

There was a focus on education innovation, increases in dollars there, that helped to increase that productivity that you, in fact, are talking about, that we have seen in the private sector because of the increase in education focus and innovation.

So now we come back to 2001, 2002, 2003, and we see again, like the 1980's, a focus on supply side economics, trickle-down economics, a great increase in defense spending, and I have voted for that given the current situation, and all of us have great concern about safety and security for our citizens. What have we seen as a result of this? We are seeing a great increase in defense spending, and what do we have now? Over 2 million private sector jobs lost in the last 2 years. We have to go back to the Eisenhower administration to find that kind of a number, and a dramatic increase in the national debt.

So I would just say to my colleagues, we don't have to debate economic theory. We have real-life experiences that we have all lived through. For many of us, we are scratching our heads as to why we would choose a 1980's economic model versus a 1990's economic model that worked.

Before asking you to respond, I would just say to look at where the economic uncertainties come from, and the CBO comments a week ago we were told that there is excess capacity from over-investment during the bubble years of the late 1990's, inhibiting investment, and that the growth of consumer spending is uncertain in the near term because demand is weak in many sectors of the economy, and that, again, strength of demand is the concern that was raised.

Now, that says to me that we need tax cuts like we have suggest that put dollars directly into the pockets immediately of middle-income consumers, small businesses, those that will move the economy in the short run. I continue to scratch my head, Mr. Daniels, as to why we are not using the approach that is even backed up by experience in the 1990's of fiscal responsibility and keeping an eye on the debt, paying down the debt, balancing the budget, and focusing on tax cuts that go directly to the middle class.

Mr. DANIELS. Well, thank you, Senator. I see things in part the same and in part differently. I take a slightly different lesson from the history. Both the 1980's and the 1990's were periods of extraordinary economic growth in this country. It is astonishing to me that people have a memory blank like some do, but I think an honest reading is both were very strong decades. We just had a 20-year run from 1982—well, 19 years—to 2001 with only one small, very short interruption until the recession which started in 2001. The lesson I would take is that there is no one model that is perfect in all circumstances at all times.

We had good results. One thing we ought to be careful about is assuming that it is what Washington does that dictates the outcome because there are always many more factors involved. In terms of those things that Government can do to create the right climate for growth, it may not be the same answer all the time.

I would certainly argue from the results that the tax cuts, which began to take effect at the depth of the recession in 1982, led to or had something to do with the gigantic increase in economic growth, 20 million new jobs and, some forget, a lot of new revenue to the Government. You quite correctly pointed out that there were other things going on. We were facing the Soviet Union. There was a lot of spending on defense and also on non-defense programs that came along at the same time and which consumed all the new revenue and more. Some people think too much more, but in terms of economic outcome, it was spectacular by any measure. The 1990's were spectacular in their own way. Certainly in the situation like that, we were able to spend the peace dividend. Most of the cuts, as you know, most of the spending moderation was achieved because of changes in the defense budget. Certainly at a time like that, it was good policy to get to surplus. People in both parties, people in this room had a lot to do with it. Get the surplus, pay down some debt, exactly the right thing.

Now the question in a very different sort of environment is what is right now, and what you have got here—we talked about this. What is the right balance of our priorities? Where do you put a balanced budget versus the war on terror, homeland defense, economic growth and so forth? Honest people can certainly differ about how high on that list it ought to be, but that is how I think I would frame it.

Last, I agree with you that if we are going to have a growth package, as the President and others believe, certainly at least a substantial piece of it ought to involve the near term, ought to involve consumers, and there are elements of his package that we believe do that.

Senator STABENOW. I appreciate your comments. My concern is that two-thirds, really, of what you propose has nothing to do with the short run and is estimated to continue to increase the national debt. Many of us, both sides of the aisle, the business community that I talk to in Michigan are extremely concerned about where we are going, back into deficit spending.

Let me shift, though, to one other item, and that is the question of health care, to follow-up on Senator Wyden's comments and others'—again, talking about to the business community. The largest cost, the explosion in costs that they are most concerned about relates to health care costs, not just seniors but the business community, workers. It is certainly the biggest drain right now and the most sense of being uncontrolled in terms of the explosion on prices and so on.

When we talk about Medicare, there are really two pieces on the health care front. One is updating Medicare in some fashion. I would argue that, in fact, anyone who has paid the payroll tax all their life in order to have health care available at the time they retired, called Medicare, who then turns around and pays the bulk of their health care and prescription drugs, which isn't covered, is being double taxed. I would argue that is much bigger double taxation than anything that the dividend tax would provide for most seniors. That is a real issue, out-of-pocket costs and double taxation.

On the business front, we have been working to create more competition as it relates to brand-name prescription drugs to lower prices. Strong evidence, major coalitions, we have all kinds of business organizations and employer groups and Blue Cross/Blue Shield-Michigan is playing a major role, and others, to create more competition to lower prices.

Last summer, we passed on a very strong bipartisan vote, 78 members voted for a bill that would tighten the generic laws, open the border to Canada to change the market pressures to be able to lower prices, and create more flexibility for States in negotiating lower prices for the uninsured in their States. This passed with a very strong bipartisan vote, and I would like to know if the Administration, as we introduce it again this year, will support that effort to lower prices, which are the largest driving factor in the explosion of health care costs.

Mr. DANIELS. Well, the President will, I am sure, take a look at anything that might help Americans with the cost of health care. You mentioned prescription drugs, which, though it is something like a dime on the dollar, is growing faster than other areas, and that is an area of concern. The President acted, as I think you noted, late last year to make sure that there wasn't abuse of the patent extension process, something that had been, I think, misused on several occasions. He tried to move repeatedly to make discounts available to especially lower-income senior citizens until we can get to comprehensive Medicare reform that includes prescription drugs. Secretary Thompson has gone a long way working with individual States along the lines you talked about to give them some flexibility to wrestle with this cost problem.

So any reasonable proposal in this area I am sure he will look at.

Chairman NICKLES. We need to move on, if you don't mind.

Senator STABENOW. Yes, absolutely. We look forward to working with you. There is certainly much to be done in this area.

Chairman NICKLES. Senator Stabenow, thank you very much.

Senator Nelson?

Senator NELSON. Mr. Director, I am going to ask you some specific questions. Having just returned from the memorial service in Houston yesterday where the President spoke quite eloquently and spoke not only to a grieving Nation but a grieving NASA family as well.

I have been quite critical in the 2 years that I have been Senator not only of your administration but of the previous administration in trying to starve NASA of funds when so much is demanded of it. Indeed, the funding today for NASA in real dollars is the same as it was 12 years ago. So it actually spans three administrations, but primarily it spans two administrations.

Now, I notice that you are coming up with beginning to give some relief in your proposed budget to the tune of close to about $470 million, but most of that is in space science. In fact, in the Space Shuttle program in your budget, you are actually—overall the space flight part of the budget is actually reducing. Where I have been so sharply critical of this administration and the previous one is that there are a number of safety upgrades that ought to be done, but yet have been delayed for funding reasons. We have been saying this for some period of time. It is ultimately going to cause a catastrophe.

Now, fortunately, in a very unfortunate world, I don't think the delay of those safety upgrades is what caused this catastrophe. It looks like this is a failure of the thermal protection system perhaps caused as a result of something like that debris falling off the external tank. The fact is that space flight is risky business, and there is no excuse for us not proceeding with the safety upgrades if we are going to keep flying the Space Shuttle, and that is our only access for humans to space. With a huge investment up there—which I have complimented Mr. O'Keefe, publicly and privately, that he is getting his arms around the cost overruns on the Space Station. I think he is to be commended for that.

Now, he knows what I have said. I would love to hear what you say.

Mr. DANIELS. Well, thank you, Senator, for your leadership in this area. I would start by pointing out—and these facts are well known to you—that were it not for the last 3 years, which were catch-up years, you would be below the level of 12 years ago, measured as you did it. In other words, it may have been inadequate—I know from your viewpoint it probably was, but the funding of NASA, I should say, in the first three budgets, including the one just delivered for this President marked the sharpest increases in that whole time period. That is true, and I would be glad to go through the piece parts with you, but as we see it, that is true of NASA, it is true of the shuttle budget, and it is also true of the shuttle maintenance and life extension budget within that. It well may be that more should have been done and that more will be necessary, but at least it has been moving in the right direction. I would say—and, again, no news to you—that there have been, as I read the record, anyway, and have seen it for 2 years, your views are not universally held, and there are a lot of your colleagues who have been skeptical and who have preferred to grow other programs of Government more than NASA. So they may be rethinking that in light of what has occurred.

Last, I do appreciate your advocacy and your pointing out this morning the importance of some improvements in some fundamental problems that NASA has had, and I think the Space Station is probably the single biggest example. If the Space Station had not been overrunning at the rate it was, more resources might well have been available for other things in a more balanced program. I think you are right that the new leadership has begun to really get a handle on that. The better job that is done there, I think the more consensus and support there will be to strengthen other programs, perhaps starting with the shuttle.

Senator NELSON. Well, in light of this tragedy this weekend, let me suggest something that you can do. There is the political will here on Capitol Hill, including Senator Stevens, in this 2003 appropriations omnibus bill in conference to put in some additional money to get some of these safety upgrades started. So what I would suggest that you could do is don't oppose that and it will happen, because the political will is here, particularly in light of what has just happened.

Mr. DANIELS. All right, sir.

Senator NELSON. Let me ask you, we have got a problem over at the Department of Housing and Urban Development. There is about a $250 million shortfall for the public housing operation fund, and, of course, I am hearing this from housing authorities back home that, as a result of this shortfall, they have been asked to reduce their operating budgets. This budget you have submitted doesn't make up for this shortfall. In fact, it even cuts it more by $40 million.

So can you tell me—give me some level of comfort. Tell me why the shortfall, and how about these authorities that are now being told because of this shortfall that they have got to cut back on their operational expenses.

Mr. DANIELS. Well, I would like to reserve the right to write you or visit you with a full report, but I will give you a quick answer now. There have been some really very serious administrative problems in many of the public housing authorities. Many are well run, many are not well run at all. The Secretary, in fact, has been compelled to take over at least two that I can think of where there is not just failure to keep track of money but misuse of funds and things like that have been going on for a long time. This is a partial source, I believe, of some of the shortfall that some have experienced. Some are simply spending money faster than they were supposed to be spending it. I would be more than happy to try to give you a fuller report.

Senator NELSON. I think that is increasingly going to be a problem, and I would appreciate very much your response.

Mr. DANIELS. Sure.

Chairman NICKLES. Senator Nelson, thank you very much.

I have to leave, and I am going to ask Senator Allard if he would chair the balance of the hearing because I understand Senator Conrad and Senator Hollings both have additional questions.

Director Daniels, a couple of quick ones from me. A little confusion may come out on on-budget/off-budget. The unified deficit that you are projecting is $304 billion or $307 billion for 2003 and 2004?

Mr. DANIELS. Presuming the President's entire program including his growth package became law.

Chairman NICKLES. OK. The baseline you are projecting, if nothing changed, would be $264 billion or something for 2003; is that correct?

Mr. DANIELS. For 2003, dropping to, I think it is $158 billion in 2004.

Chairman NICKLES. That is the cash-flow. I think a lot of people, members included, really get kind of confused on-budget/off-budget, Social Security surpluses and so on.

A couple of other comments. Just maybe—and I am going to present this to our colleagues a little more in-depth, but the total tax, the payroll tax, the 15.3 percent Social Security and HI tax is on wages up to $87,000 this year. Anyway, back in last year, the last year just complete, if my calculations are correct, the total amount of money going in, received in payroll taxes and the Part B premiums I believe equaled $691 billion and the expenditures, Social Security and Medicare, were $706 billion. I believe your proposal or estimates are $711 billion in receipts and $743 billion in outlays, the point being if you add the two programs together—and people talk about raiding or stealing Social Security funds and so on. There is a lot of confusion. If you put the two together, we are actually spending more on the programs than we are taking in, so I don't quite concur with this claim about raiding of the funds because we should include this or not add that to the calculation.

I make those comments, and I will work with my colleagues so we can all have maybe a better understanding. It gets kind of confusing because you have the Social Security funds and the HI funds, and then you have general revenues, subsidies into Part B and so on, so it is kind of confusing. The total amount of money, payroll going in and outlays coming out for basically seniors under the two programs, there is a little more going out than going in, so there is not—if you combine the two there is not really a current surplus. Is that correct?

Mr. DANIELS. It is correct, and you point to the reason: because Medicare viewed in its entirety runs a deficit. That is to say, it has to be subsidized heavily by the general fund and the taxpayers who pay into that.

Chairman NICKLES. The same beneficiaries on Medicare are the ones that are also receiving Social Security.

Mr. DANIELS. More or less.

Chairman NICKLES. OK. Senator Conrad, I will call upon you, and then, Senator Allard, if you would be kind enough to conclude the hearing.

For the information of our colleagues and press, we expect our next hearing to be on Tuesday with Secretary of State Colin Powell, and that will be at 10 o'clock. So, again, I thank my colleagues for their indulgence, and thank you, Director Daniels. I apologize. I need to run for another meeting. Thank you.

Senator Conrad, I was going to call on you, then him, then Fritz.

Senator CONRAD. It seems to me it is unfair not to——

Senator ALLARD. I have already asked my questions.

Senator CONRAD. Oh, you did. OK.

Chairman NICKLES. You didn't hear what he said? [Laughter.]

Senator CONRAD. I was obviously not paying very close attention. I apologize.

Director Daniels, again, first of all, I want to say I appreciate your public service, and I think you are a straight shooter. I have a profound disagreement with you on what is the wisest course for the Nation, but that is what democracy is all about. I want to make clear, because we have strong differences it doesn't mean I have a lack of respect for you. I have respect for you. I think you know that.

Mr. DANIELS. You know it is mutual, Senator.

Senator CONRAD. I even enjoy your company from time to time. I do have a profound difference.

Let me first try to correct the record. We have had a number of colleagues on the other side say that we voted on a package of $540 billion of amendments on the last appropriations bill. We did not. We voted on these amendments, and they totaled $37 billion, not $540 billion. These were 1-year appropriations amendments. What were they? Improve homeland security, $5 billion; improve education, $6 billion.

Now, in addition, these amendments were not voted on as a package. They were voted on individually. So the first amendment failed, $5 billion to improve, strengthen homeland security. It failed. So that money was not used.

So then there was a vote to improve education using that $5 billion plus another $1 billion. That failed.

So then there was an amendment to deal with Amtrak because Amtrak was going to shut down without it. That was adopted.

Then there was an amendment on strengthening law enforcement. That was for $500 million. That failed.

So totaling these amendments even for the year is not correct. That isn't how we voted. We didn't vote on a package of $580 billion or $540 billion or whatever number keeps being thrown around. It is just not accurate.

Let me go to the longer term. Senator Cornyn made a point about outlays and receipts, and this is looking at the long term. This is from 1980 and going ahead with the President's policies to 2008. We can see outlays as a percentage of GDP have come down. We have got a reversal last year because of the need for additional spending on defense and homeland security. That is where the increases have come from.

On the other hand, the revenue line has dropped precipitously, partly as a result of the economic downturn, partly as a result of the stock market drop, dramatic drop. You are absolutely correct that that is a factor. Also partly because of tax reductions, tax cuts. We can see where we are headed if we continue on the President's plan, which will add, according to the President's own analysis, some $1.8 trillion to deficits and debt. The size of tax cuts, including the associated interest costs, and that is on top of the $1.3 trillion passed in 2001.

So that leaves us with this gap, and the thing that I think—let's go to the next chart. The thing that most concerns me is what Senator Hollings has been trying to alert us to is hard reality. When we talk about these deficits, we talk about the gap, as you indicated, and Senator Nickles did, cash-flow differences. That is the deficit. What that doesn't own up to is the money we owe the trust funds because indeed there are separate trust fund. I know Senator Nickles wants to combine them, but that is not the way they are set up. They are separate trust funds. Both the Medicare and Social Security Trust Funds are running surpluses. Part B of Medicare is funded in part by general fund money. That was an agreement made here long ago as a way of funding Medicare Part B.

Social Security Trust Funds, Medicare Trust Funds are currently running substantial surpluses. Instead of using that money to pay down debt or prepay liability, that money is being used to pay for other things. Here is what we see. According to the Administration's own document, we have just got red ink to look forward to in the future.

Let me just put up an ad that ran, the Concord Coalition, a bipartisan group. This is an ad signed by Warren Rudman, former prominent Republican United States Senator, signed by Peter Peterson, prominent Republican, former Secretary of Commerce, signed by Robert Rubin, former Secretary of the Treasury, signed by Senator Nunn, prominent Democrats, a former Democratic Senator. What they are saying is: Are we really cutting taxes or are we just raising them for our kids?

The point they make in this—I just want to read from this and ask the Director. What they say here is: "Guns and butter and tax cuts, can we have it all? To enact permanent new tax cuts in the face of large new spending pressures such as the prospect of war in Iraq, the inevitable post-war costs, massive but indispensable homeland security needs, and a major prescription drug add-on for Medicare is to proclaim that America can painlessly have it all. Unfortunately, we can't. Sooner or later, someone has to pay the bills for guns and butter and tax cuts. Many worry about class warfare. Almost no one seems concerned about another kind of warfare, generational warfare. Yet that is what we risk if we continue to live beyond our means and pass the IOUs to our children and grandchildren."

Their conclusion is that we have got these unfunded obligations out here, Social Security, Medicare, civil service and military retirement, $25 billion.

What part of their statement do you disagree with?

Mr. DANIELS. There are many parts of their statement I agree very strongly with, and let me start with that, and then I will answer your question. I think both your chart and their advocacy, the coalition's advocacy over time, and Senator Hollings, all point us to the real, the largest problem, not to dismiss any of the problems we are wrestling with this year or next year, but the largest problem is the unfunded entitlement. That is the big swing in your chart, about 2013. It is really not the product of the deficits, although we would all like to make them smaller and we hope we can. It is all overwhelmed by the effect of the mismatch between the promises we have made and the revenues coming into those programs the way we have them set up now.

I think the Concord Coalition would agree, although they may have a disagreement in this year about the growth package. I believe I am right in saying that they would agree with me that we cannot tax our way out of that problem. We are going to have to have fundamental reform of those programs if we are really going to avoid that, that ski slope that you saw there. So on all those things I would agree with them, and perhaps we here all agree. I think the question immediately before us is twofold.

One is: should we aggravate the deficits that circumstances have brought us? Should we undertake some new borrowing in order to have a growth package? Some say yes, and I think there are some who say no. Then second, if so, what kind of package? There are a lot of ideas. The President's put his forward, and Senator Stabenow and others have suggested some alternatives to that. Those are important debates to have, and we can have a very different deficit outcome this year and next, depending how we answer them, but you do have to weigh that against the perhaps lost opportunity of putting more people back to work.

Senator CONRAD. Let me just conclude by saying this to you. I personally support tax cuts this year to give lift to the economy. In fact I would support a bigger package than what the President has proposed. What I find dangerous and I believe is radical and reckless is the President's plan for additional tax cuts in future years that explode the deficits, explode the debt. Making the tax cuts permanent, which is proposed, costs 600 billion this decade—I think 600 billion is the estimate—costs 4 trillion the second decade, right at the time the baby-boomers retire. So you are making the circumstance that we face with Medicare and Social Security where we would agree we face massive long-term imbalances. You are making our ability to deal with that far more difficult, and presenting the country with what I think in the future will be truly draconian choices.

Further, I believe that adding to deficit and debt when we are already in deep deficit and debt will not enhance economic growth but inhibit it. Because of the dead weight of that deficit and debt, will reduce the pool of societal savings, will reduce investment, will reduce economic growth, not improve it. That is where this debate lies. It is an honest difference.

I am alarmed. I do not want to hide it. I think this is a profound mistake for our Nation, not shortcuts in the short term to lift the economy, but these deep permanent cuts when we already face demands we cannot finance.

With that, I again want to say to you, I respect your public service. It is not easy to be in your position. It is certainly not easy at a time like this. Let me thank you for your appearance.

Mr. DANIELS. Appreciate it.

Senator ALLARD. Thank the Senator from North Dakota, and I would just say that I am pleased to see that you would support some tax cuts, and I think there is room perhaps for some compromise. As one member of this committee, and I think the Chairman will agree with me, that that is certainly a step in trying to get some kind of bipartisan proposal out of this committee, and so I want to compliment you for that outreach I think to the other side.

I would just want to put in my two bits as far as permanent versus temporary tax policy. I think that temporary tax policy, although it has a positive impact on the economy, that a permanent tax policy has more of an impact as far as long-term economic growth is concerned, because I can recall my experience as a businessman. Your decisions are going to be—your long-term decisions will not occur, unless there can be some assurance that that long-term tax policy is going to be in place. When we have temporary short-term tax policy I think that there is—you are not going to make those long-term decisions, and so you do not have as great an impact to the economy.

I am wondering if you have taken, Mr. Daniels, an opportunity to kind of look at the difference in long-term economic growth—and you are going to have to use an economic model which we do not use around here—but you ar going to have to use—if you have looked using a dynamic approach, what might be the difference in economic growth between say a package of cut packages that only go out for 5 years, as opposed to 10, as opposed to permanent?

Mr. DANIELS. Senator, I do not know. I think the President would share your common sense view that predictability is worth something. That is to say at the margin more businesses and individuals will make those decisions you talked about, hire that next employee, risk that next dollar when they think they know what return they can expect over time.

I guess my reflection on this whole business of permanence—and therefore, the course the President supports making the cuts permanent. My reflection on this is there is not anything permanent about taxation the way we do it. We jerk this system around every so often, and I think it would probably be a very good thing to make the tax cuts permanent and just step back and leave it alone for the next 8 or 9 years, but odds are that will not happen. Circumstances change, the composition of Congress changes, and I am a little bemused by the debate that sort of suggests that it is all or one. You know, the cuts that are in place I think may well be challenged before they ever take effect, before they ever show up on Senator Conrad's charts. As we pointed out earlier, very little of that 1901 Act has taken effect so far. If Congress changes its mind, it could take that effect away tomorrow or next year or the next year, all kinds of multiple shots at it. So I am just thinking out loud here a little bit, but to me, as good a principle as permanence versus temporary is, let us be realistic. I mean this is a debate and a conversation that is going to keep on going every year.

Senator ALLARD. Thank you for your response. I want to bring up another subject on the total debt. I think of it in terms of the total obligation on the General Fund, and I am looking at some figures here where over time, where we have the total Federal debt as a percentage of gross domestic product, there are some pretty substantial figures there, and that includes not only what you pay out what we would call the public debt is—that is interest and everything that you are paying out to the public—but it also includes future obligations to the General Fund as far as Social Security and the other trust funds, where those moneys get automatically transferred into the General Fund.

When I look at that as a percentage of gross domestic product, has there been any discussion as to where that percentage could begin to have a real dramatic effect on economic growth, or do you just totally disregard it all together? I look at it as a public policy here. I am thinking, well, Social Security, both sides I think generally agree it is around 2017 Social Security is going to be spending more money than what it brings in in revenues. Then that is either going to mean a tax cut or it is going to result in a cut in benefits, or it is going to result in having to pay that money out of the General Fund, repaying what has been borrowed over these years. I think that is going to create a real challenge as we get closer.

I am wondering if you looked at that sort of—there is a whole bunch of complex issues there. I wonder if you would make some comment on those for us, please?

Mr. DANIELS. I do think the total level of debt is something to be concerned about, something to watch, something we ought to try to make sure is controlled and reduced. That is true whether you measure it in gross debt or the debt actually outstanding in public hands. Clearly there are many nations of the world with a much bigger debt burden than we have. They tend to be the nations that already are facing an entitlement crunch that they constructed for themselves, and are getting there a little sooner than we are. I do not know where the red line is. A look at the history says we are not there now. We have been at much higher levels at different times in the past, but it is certainly something that the President and this administration keep a weather eye on and want to see brought down.

The best way to do it, of course, is to have an economy that grows fast and outruns any borrowing that might be going on. That is how we brought it down most effectively in the past.

Senator ALLARD. The Senator from South Carolina.

Senator HOLLINGS. Thank you, Mr. Chairman.

Director Daniels, you just heard the Concord Coalition, and Senator Conrad observed that you cannot take it all, and you cannot have it all, and the way you said you cannot go in two different directions at the same time. I am back now to the observation that our distinguished astronaut, Senator Nelson, he was going right on down the list of how he was worried and how we had cut the budget and everything else like that, but then did not find us by any manner or means at fault. That worries me.

I speak advisedly. I remember when we used to have just a singular Space Committee with the Senator from Utah, Ted Moss, heading it up. Otherwise, I have been intermittently either the Chairman of the overall or ranking member of the overall Commerce, Space, Science Transportation. I could see about 15 years ago in the mid 1980's with that space station, that we could not afford both the space station and the shuttle. I admonished our friend, Sean O'Keefe when he came over—he used to be your Deputy Director—and Senator Nelson. I have got the highest regard for Sean O'Keefe. He was not sent over to NASA. You see he worked with us on the Appropriations Committee. He worked the Secretary of the Navy, then as your Deputy Director, now the Administrator of the National Aeronautic and Space Administration. He was not sent over to increase the budget.

I said, "I know you are over here trying to get on top of those overruns," because that is the reason we could not afford both. An $8 billion space station was all of a sudden $100 billion space station. Right to the point, Senator Nelson, these little upgrade you talk about, not going to do it. I do not think the team down there at Canaveral was shortchanging upgrades. I think they tried, and will find that they did everything possible on upgrades. They might could have had—and the astronaut can tell us about a procedure. I was wondering why they were not drilled and given the equipment to dock up with the space station and come back, if they observed critical damage had occurred when the insulation came off and knocked that wing. Then why cannot we go to the space station and then another shuttle come up uninjured or undamaged and save us?

We have found out and we know that the particular vehicle, the shuttle itself, was of a 10-year duration. That is what they said they would last. Now we have had the Columbia 22 or 21 years, and you cannot upgrade those tiles. I remember the first one that went up, the tiles flew off, and they have been flying off now for 20 years. What really needed to be done and needs, present tense, to be done is get us a new vehicle, not just upgrades. We could not get into the research and back the shuttle program.

I told Sean when he came over. I said, Now, I am for the shuttle. You got a tremendous national value and investment here in these astronauts, takes then a long time, the best of the best Americans, and they are coming into this program and everything else like that, but we are not giving them—I do not know what that space station's going to do. I never have been, frankly, I have to plead guilty, I have never been enthused about it, because the shuttle can go up—this one went 16 days or whatever it was—and the experiments can be had.

So give us the figures, Director Daniels, of what was requested by NASA for the space shuttle and what was approved by the Director of Office and Management and Budget. Not just your 2 years. Go back under Dan Goldin. Go back further than him. You will prove the point that Senator Nelson has made. They have been stultified. They have been starved. Coming up here and playing this sordid game of, yes, we all want defense, we all want homeland security, we all want health care, we all want space, we all want, we all want. That is the needs of the country. Then the needs of the campaign says, I am for tax cuts, I am for tax cuts. It is a total fraud to talk about stimulating it with 133 or 143. Senator Daschle is 143. President Bush is 133. At 12 billion more a month, you are putting in, as I said, $554 billion, Senator Domenici, this year is the estimate of the deficit, and 569 billion next year. That is a trillion stimulus there. So 12 billion a month more is not going to do it. I am for paying the bill.

Now you say—and the intimation was with all of those senators present, they thought, well, old big mouth Hollings, he is talking one way and going in another direction. No. I believe in that freeze. In fact I was Chairman of State, Justice, Commerce Appropriations, and with Senator Judd Gregg, we froze that appropriation.

We made an exception for the Securities and Exchange Commission, but we froze it. We have been operating at a frozen continuing resolution. I put in a value-added tax to pay for the war. You see, I do not want to just freeze spending. I want to freeze revenues, freeze taxes. We cannot afford to cut revenues, because we are just passing it off, as the Concord Coalition says, to the next generation. That is all it is.

Please, there is that chart there. As far as paying for the war, I cannot stand to send those fellows into Afghanistan and Iraq and say, by the way, I got to go to Disney World. I cannot afford to pay for it. Do not give me the economics argument about stimulating. That is no stimulus at all, neither one of them are.

Secretary O'NEILL was right. He said it is not stimulus. We have got plenty of stimulus in there. We have got to start doing what we did in 1993. We had—you say history. I remember the history. We had high unemployment in 1992, 1993. We had low consumer confidence. We had a $400 billion deficit in 1992. So we had a lot of similarities. We went with Alan Greenspan, who says you are not only going to have to cut spending, you are going to have to increase taxes. Our problem is they invited Charles Schwab and he says cut the taxes on dividends. Come on.

So here is what we have done. All of America has already paid for the war. In the Civil War they raised income tax and tax on dividends. Down here now we put a tax cut. World War I the rate went up to 77 percent; World War II, 94; Korea, 91; 77 percent in Vietnam; and a 52 percent for corporations, and we paid for it. We believe in at least not just committing them to battles, but do not ask them to come home and get the bill. Come on.

So that is our problem right there now. I know you believe in taxes. I see Senator Domenici is here. In trying to be fiscally responsible I authored the Seaport Security Bill last year, and from May until November I argued about paying with a use tax. We had a little use tax on on a container of around $17 for 40,000 pound of textiles or pharmaceuticals or whatever. It was just a little 17 bucks use tax. You folks at the Administration call it a tax, that would be increasing taxes. The House members said, we cannot vote to increase taxes. I see by the morning paper you are increasing taxes on meat producers. You are increasing taxes on Medicare claims. You are increasing taxes on veterans. All of those are use fees. But last year when I was trying to pay the bill and be fiscally responsible and not go in two different directions, they were increasing taxes. Now you call them user fees.

Cannot we go along, just a VAT, because it will take a year for the IRS to pay for the war? Do you not believe in paying for this war? Do not worry about deficits right now. Let's get the country serious. They are ready for a sacrifice, and I am convinced you are agreeing with me, but you are constricted by the White House, are you?

Senator ALLARD. Mr. Daniels, I would ask that you make your comments short so that we can get to Senator Domenici.

Mr. DANIELS. Well, I will just thank the Senator for his comments. It is a legitimate point of view. I think each of those wars was paid for by a mix of taxation and borrowing. We had borrowing in some of those wars far more than we are looking at now, and the question is, what is the right balance, what is the right balance in view of everything, the conflict, the state of the economy and so forth? But yours is an honest and legitimate viewpoint and deserves to be heard.

Senator ALLARD. Senator Domenici.

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

First of all, to all the staff and you, I apologize for being so late and continuing this hearing, but frankly, I was cheating and watching Secretary Powell, to be honest with you. I guess I am very pleased to say that it was a great, great presentation. But I think with reference to some of the points about spending money, we frequently wonder, some of us around here, what is in the CIA's budget, because an awful lot of it we do not approve in open, but, boy, that was just an hour and 20-minute discussion just loaded with disclosing what we do by way of surveillance which was rather incredible. I would think the skeptics will not think as much about it as I do, but I believe it is about as conclusive as you are going to get.

Let me ask just about 10 questions. One, what would you say is the percentage debt, not deficit, but debt to GDP, where a country of our type gets, where it gets powerless? I am not speaking now of—I am speaking of the conventional debt to the public, not inside debt.

Mr. DANIELS. Senator Allard and I talked a little about it, and I do not know exactly the number. I would say that this nation has been successful and prosperous in the past with levels higher than we have today, so I do not believe we are at that level today. I do believe there is a level beyond which you would not go or should not go. I do not know precisely where it is, but I think it is north of where we are.

Senator DOMENICI. Do you have the capacity to go beyond the 5 or 10 years and see what it would be in 15, 20 or 30 years in terms of this debt versus GDP, or is that beyond your capacity?

Mr. DANIELS. It is beyond our capacity, and I——

Senator DOMENICI. I think the Congressional Budget Office is doing it and I think Alan Greenspan is doing it, because it is pretty obvious that is the time it will get dangerous in terms of debt.

Mr. DANIELS. We can give you a number. It is just that I have—I just think we have to be mindful how far off it might be.

Senator DOMENICI. Right. Second, I note that we are bragging now about the amount of interest we are paying, and that is good, but it is principally because the percentage that we pay, the cost of debt is dramatically reduced. I recall when it started coming down, we were busy trying—excuse me. When it was high we were busy making it short term, hoping it would come down. Have we made the transition toward more of the debt being long-term debt now that it is down in the 3-1/2 or 4 percent, or is it still short term?

Mr. DANIELS. That is a question for Peter Fisher and Secretary Snow. I do happen to know that we, like a lot of Americans, refinanced the mortgage pretty successfully, and my recollection from talking to Mr. Fisher is that something on the order of 40 percent of the debt did turn over in each of the last 2 years, so that you are exactly right that despite the fact that we have slipped into deficit, our borrowing costs have actually gone down, and they are as low as they have been in 20 odd years.

Senator DOMENICI. See, if somebody were to ask me about a home mortgage, and they said, I am going to get 5.8 percent, and my next question would be the terms. Is that 1 year or 5 years? I would suggest they get 15 or 20 years at that rate. I think, unless there is something different about the Government, when rates are at 3.4 you ought to get as much of the debt out there as you can, not as little. Could you just look in the record and tell us for the record where we have been and where we are going?

Mr. DANIELS. I do not know what the average maturity has been, but we will get you that answer.

Senator DOMENICI. Thank you. I noticed in the staff preparation, which I found to be very good and I compliment you on it, there is a series of observations regarding PAYGO, and there is something that I do not quite understand. It says that the President's budget proposes a number of cap adjustments, one of which is entirely new, the one with respect to building of nuclear waste repository at Yucca Mountain. Is that the one that is entirely new?

Mr. DANIELS. I suppose. If there is only one that is new, that is it.

Senator DOMENICI. What is it? What do you do with Yucca Mountain that is different that we call it a cap?

Mr. DANIELS. I would like to write you a letter about that if I may, Senator. It is a complicated subject, but the idea is, I believe, that we may have large and lumpy costs associated with that facility, and we would like to treat them separate from a predictable cap.

Senator DOMENICI. Well, we have got the expert there sitting behind you. I know that. He used to work for me. He knows more than anybody else. But as long as you are not attempting to abolish the trust fund. The way we have treated trust funds, I will support. If you are going to take that in an isolated manner and say it is no longer to be treated as general revenue, we have got a lot of others who want to joint that parade, so it is not that; is that correct? Just a yes or no on that. It is not that?

Mr. DANIELS. I think that is correct, but let me——

Senator DOMENICI. He is saying I am correct, so we can say it.

Mr. DANIELS. I never pay attention to them. [Laughter.]

Senator DOMENICI. I would like to know what it is. It has been up and down, not only because of costs, but we have been very reluctant appropriators, as you know, because of personalities and other things.

Mr. DANIELS. Yes.

Senator DOMENICI. The President's budget proposes that we extend the use of, quote, "emergency designation." That has always been a disputable item with respect to both discretionary caps and PAYGO. Please explain to me what are we doing different? It says that we are going to change the process. The President's budget proposes that we extend the use of emergency designation.

Mr. DANIELS. Well, let me say this about the whole idea of caps. We think this is—we would like to indicate the President's support for renewal of a Budget Enforcement Act, including those two features. We know it is this committee's and this Congress's prerogative to take the lead here in exactly how that ought to be designed. So we did not presume to go further than laying out a few principles as to emergencies. We would like to make sure it is written in a way that minimizes misuse of this. Ultimately the President can try to enforce that, but it was used occasionally in the past to get around the caps, and we do not want that again.

Senator DOMENICI. Could you explain that to us also? I would think this is extending the way we have heretofore treated emergency designation vis-a-vis emergency spending, but I am not quite sure from the summary that that is the case.

Mr. DANIELS. That is what we intended, but we will follow-up.

Senator DOMENICI. Could you, if you do not have it at your fingertips, state it for the record—and you might have been asked this—the exact amount of the growth in domestic spending year over year, as best you can do it, excluding defense, obviously, and excluding homeland defense, even though some of homeland defense has heretofore been in discretionary. It might be a little bit difficult, but what do you assume the growth in domestic, as I have defined it, is?

Mr. DANIELS. If I heard you right, Senator, domestic discretionary spending, so exclusive of defense and what we call homeland security.

Senator DOMENICI. Go ahead.

Mr. DANIELS. 3.8 percent, and so this would be 11, $12 billion, something like that.

Senator DOMENICI. With reference to that category, could you tell us for the record what programs you have suggested for elimination if any, and what programs you have suggested should be reduced by more than 5 percent?

Mr. DANIELS. Well, not all of them from memory, but I will——

Senator DOMENICI. No, you do not have to, just state them for the record.

Mr. DANIELS. We absolutely will. Let me just cite, for example, there are 45 programs, most of them small and of recent vintage at the Department of Education that we proposed for elimination, those funds to be redirected and more to other programs, but those are some good examples. There are some programs that were set to expire that we propose to let expire.

Senator DOMENICI. Might you have one of your analysts tell us comparably, how many programs have we eliminated over the past 5 years that you all know as budgeteers?

Mr. DANIELS. Sure.

Senator DOMENICI. Put that in the record so we will have it when we begin debating this.

Homeland Security, well, we do not have anything to compare it with in the past. I assume you are doing your best to compare it with the 1903 appropriation for Homeland Security. How much does Homeland Security go up under however you figure it?

Mr. DANIELS. As a category it goes up 7.6 percent. Now this does not count that part of it that is at the Department of Defense. That is another 6 to $7 billion. But most people, when they ask us this, they are thinking about the activities of guarding our ports and our airports and better intelligence and all, infrastructure protection and all of that. So the answer to that is 7.6 percent, more or less from 32 billion to 35 billion.

Senator DOMENICI. In reference to the increases in defense, how much do you have as your estimate of growth in the defense spending? You have already told us that.

Mr. DANIELS. It is 4.2 percent, and that comes to—it is calculated at $10 million plus inflation. That is the steady track that the President and Secretary Rumsfeld and I have settled on and put into both the baseline of the budget, both into our forward policy I should say, and into the—it is matched exactly in the Future Years Defense Program. This may be—as far as I know this is the first time you have actually had inconsistency there. In other words, there have been a lot of times in the past there was a so-called FYDE (fid-up), that had all kinds of ideas in it that were not reflected in anybody's planning or the eventual budget. We are trying to make this thing much more business like and predictable.

Senator DOMENICI. Just an observation. Seeing the staff behind you there and some of their valiant efforts with reference to what the U.S. Government could count on with reference to the selling of—what do we call it when we sell to the telecommunication companies?

Mr. DANIELS. Auctions and spectrum auctions?

Senator DOMENICI. Spectrum auction. I note that after all these years and all the people in Government telling us we would win that case, we lost it in the Supreme Court, right? We lost all that money we thought we were going to get. I would have bet money the other way as a lawyer, but they have made some pretty good history about what a bankruptcy does to a Federal license. It does not matter how much you owe the Government, it is just like any other asset.

Mr. DANIELS. We should have settled that case.

Senator DOMENICI. Should have, you are right. We had a pretty good offer is my recollection. After all the work the staff did, we had a good offer.

One last question with reference to the stimulus. Why is the stimulus in the first year so small?

Mr. DANIELS. We've got it down at $40 billion. You are right, it is relatively small. It is our best estimate. It matters a lot what the timing of passage would be, and even if Congress moves quickly, we would not see it passing with too many months left in the fiscal year. So it is worth noting that if the President's package passed intact, it would have much more effect, 113 billion in the next fiscal year, as we count it anyway today, than about 39 to 40 in this year.

Senator DOMENICI. While we all would like tax cuts and tax reform, it would seem to me that more is needed in the first year rather than the second year if you are looking at stimulus. If we are looking at we would just like to cut taxes, it might seem we cut them any year and that would be good. But there was no way to come in with more in the first year that made sense; is that it?

Mr. DANIELS. Well, that was just our best faith estimate, but I think the President would agree with you. If the Congress did decide to move quickly, he would be happy about that, and of course, some of the provisions are retroactive to the 1st of January, so he clearly agrees that we ought to move now.

Senator DOMENICI. Yes, a lot of them are.

Mr. DANIELS. As fast as we can.

Senator DOMENICI. A lot of them are retroactive and thus count in the early years, but some are adding them as if they continue to count again, as they put the two packages together.

Mr. DANIELS. That is right.

Senator DOMENICI. Some are pulled back and thus should not be counted twice. Can you do that for us on a separate account? Can you tell us how much of the taxes are moved forward that were already in place and would have come into effect in the out years?

Mr. DANIELS. Oh, yes, absolutely.

Senator DOMENICI. Just tell us what that is. My guess is it is a pretty good chunk.

Mr. DANIELS. Yes, it is.

Senator DOMENICI. I have no other questions. I thank you for the good work, and I hope all the staff are doing well over there. I never see Capretta over here. I guess there are no issues with reference to Medicare or Social Security.

Mr. DANIELS. We have him working too hard, Senator.

Senator DOMENICI. You hired him out?

Mr. DANIELS. We've got him busy. He is working on Medicare.

Senator DOMENICI. Thank you.

Senator ALLARD. Thank you, Senator Domenici. You always bring a very interesting perspective to our discussion.

Mr. Daniels, thank you for showing before this committee.

Mr. DANIELS. Yes, sir.

Senator ALLARD. Appreciate your time and effort.

Mr. DANIELS. Thank you.

Senator ALLARD. The committee is adjourned.

[Whereupon, at 12:42 p.m., the committee was adjourned.]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

THE DIRECTOR

February 19, 2003

The Honorable Bill Nelson
United States Senate
Washington, DC 20510

Dear Senator Nelson:

During the Senate Budget Committee hearing on February 5, 2003, I mistakenly attributed the $250 million shortfall in the Public Housing Operating Fund in FY 2002 in part to faster-than-necessary spending by some public housing authorities. While there have been serious management failures in some public housing authorities across the country, the administrative failure that contributed to the recent shortfall is the Federal government's responsibility.

One cause of the funding shortfall in FY 2002 was HUD's failure to change its accounting and reporting systems to support a formula change in 1999. The inappropriate accounting practices used by HUD throughout the 1990s led to spending money out of the subsequent fiscal year's appropriation to solve the prior year's problem. Despite a 1999 pledge by the HUD Secretary not to engage in "backfilling" the operating subsidy account, this practice continued -- unnoticed -- until discovered by HUD Assistant Secretary Michael Liu, who immediately formed a plan to end this inappropriate practice.

In 2003, HUD asked Congress for authority to use $250 million of its FY 2003 appropriation to correct the uneven distribution of FY 2002 public housing operating funds. With combined funding between the two fiscal years, housing authorities should receive 95 percent of their estimated need. HUD is also deploying a new accounting system to better track and estimate funding requirements to prevent mistakes like this in the future.

Thank you for this opportunity to correct the record.

Sincerely,

Mitchell E. Daniels, Jr.
Director

Democratic Amendments Offered to Senate Omnibus Appropriations

Successive Amendments Offered Only After Others Failed to Pass

(in billions of dollars)

Amendment	Purpose	Outcome	Cost
Byrd	Homeland security	Defeated 45-51	5.0
Kennedy	Education	Defeated 46-51	6.0
Murray	Amtrak	Adopted	0.4
Harkin	Law enforcement	Tabled 52-46	0.5
Byrd	Strike ATB cut	Defeated 46-52	11.4
Reed	Unemployment insurance	Point of Order	6.3
Nelson (FL)	Famine relief	Adopted	0.5
Daschle	Agriculture disaster relief	Defeated 39-56	3.2
Durbin	Global HIV/AIDS	Adopted	0.2
Dodd	IDEA	Adopted 88-4	1.5
Murray	Community access	Adopted	0.4
Clinton	Medicare	Point of Order	0.1
Kennedy	Minority health	Tabled 51-46	0.6
Cantwell	Workforce investment	Tabled 50-48	0.7
Bingaman	SSA Q-1 program	Adopted	0.0
Byrd	Miner's Health	Adopted	0.0
Lautenberg	Superfund	Tabled 53-45	0.1

Nuclear Waste Repository at Yucca Mountain
Proposed Discretionary Cap Adjustment

Background

- ***Overall Discretionary Caps*.** The Administration's reauthorization proposal for the Budget Enforcement Act would establish discretionary caps for 2004 and 2005 at the levels proposed in the President's 2004 budget, enforced by sequestration of discretionary spending if the caps are exceeded.

- ***Adjustments to the Discretionary Caps*.** The proposal proposes four annual adjustments to the general purpose caps for: Social Security Administration program integrity initiatives, the Earned Income Tax Credit Compliance Initiative, fully accruing Federal employees' retirement, and the Nuclear Waste Repository at Yucca Mountain.

Yucca Mountain Adjustment

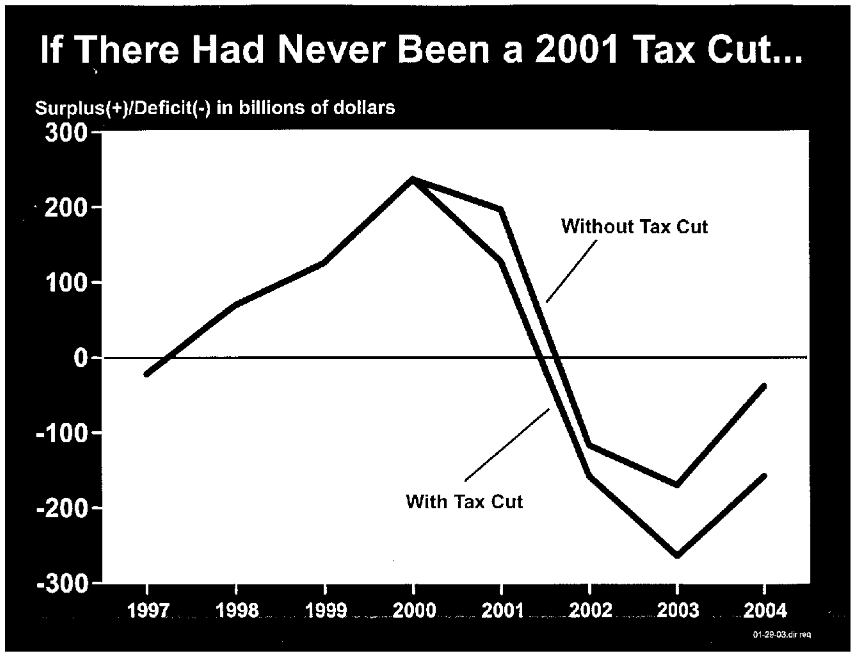
- ***Description*.** The cap adjustment would equal the amount appropriated for developing the repository at Yucca Mountain that exceeds the amount appropriated in 2003, as long as the total amount appropriated does not exceed $591 million in budget authority in 2004 and $1,055 million in 2005. These limits equal the amounts included in the FY 2004 President's Budget request for Yucca Mountain development. Corresponding cap adjustments would be made for the associated outlays in both years.

- ***Purpose*.** The purpose of the cap adjustment would be to reduce the uncertainty concerning out-year funding levels for this large, one-time construction project, which would enable the Department to execute the multi-year development effort in a more timely and cost-effective manner. The cap adjustment would also ensure that the proposed additional funding for Yucca Mountain is not diverted to fund other discretionary spending.

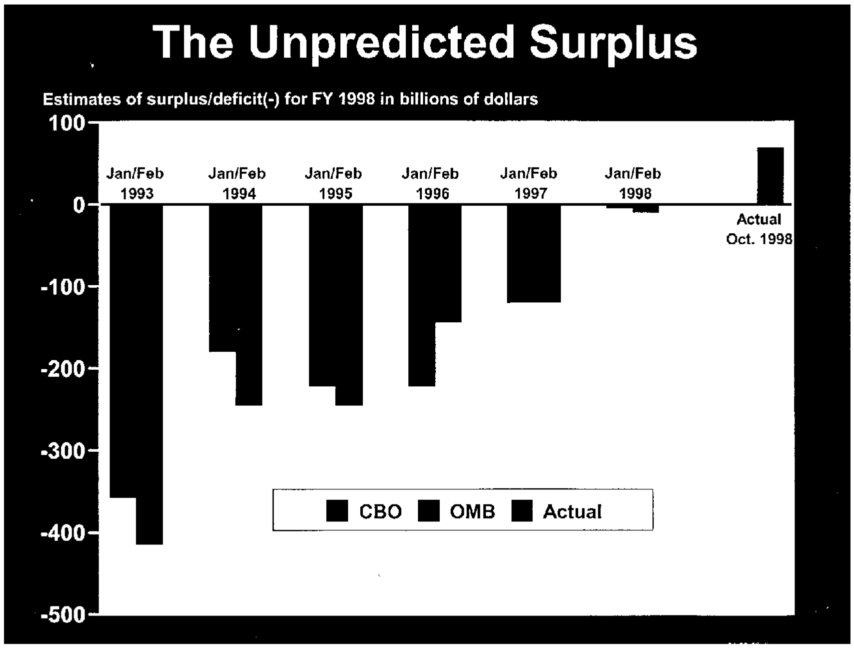
- ***Out-year Commitment*.** Since development of this facility is expected to continue into the next decade, the Administration would expect to continue this adjustment with each BEA reauthorization until the facility is complete.

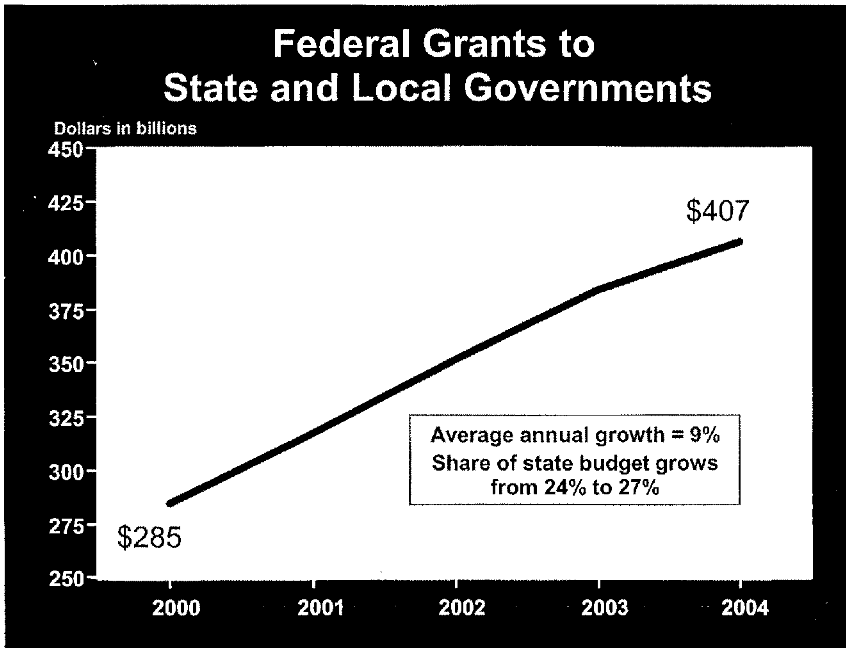
Estimates of Yucca Mountain Funding and Associated Cap Adjustments
(Budget authority in millions)

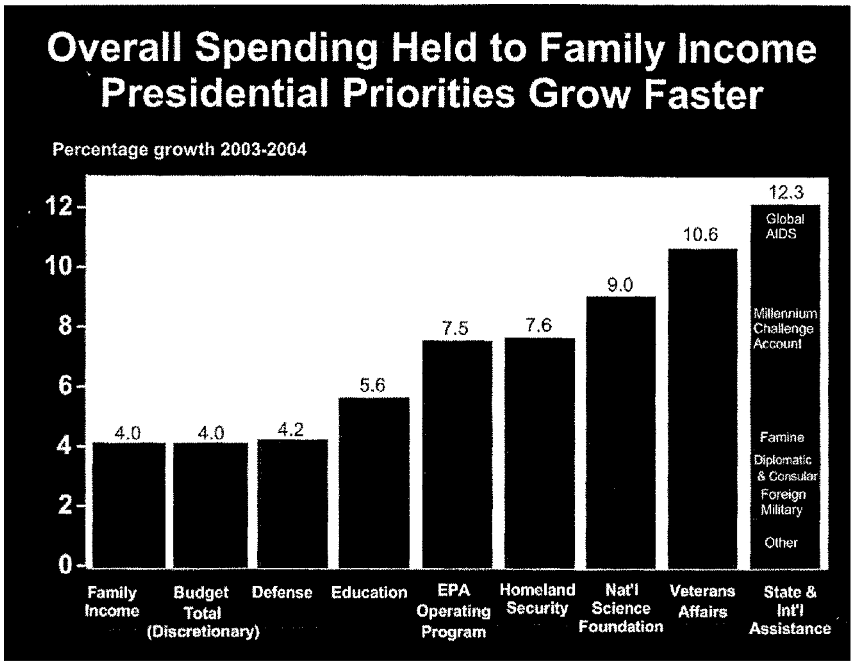
	2003	2004	2005	2006	2007	2008
Yucca Mountain Funding.......	460	591	1,055	1,107	1,102	1,645
Associated Cap Adjustment.....	NA	131	595	647	642	1,185

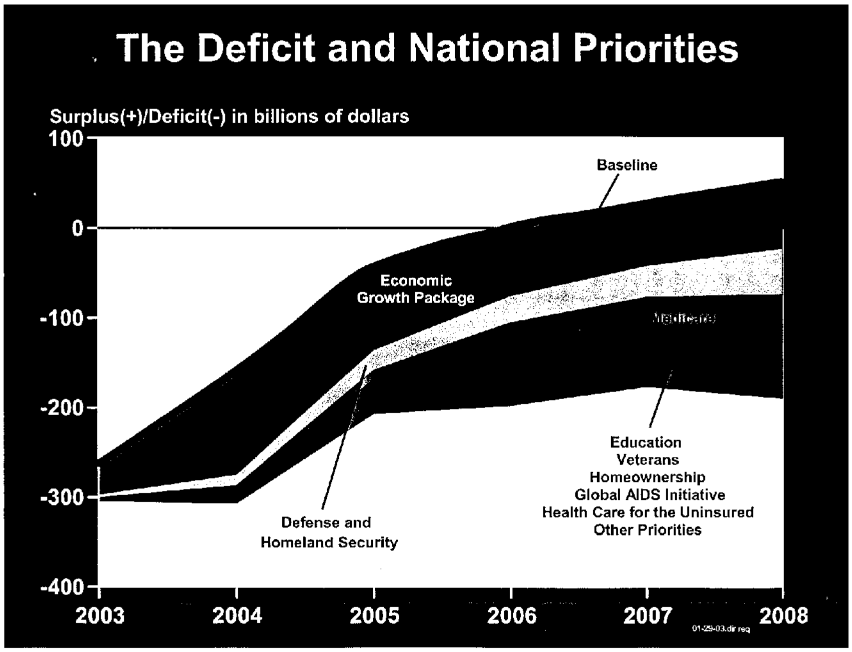


If There Had Never Been a 2001 Tax Cut...
Surplus(+)/Deficit(-) in billions of dollars
300
200
100
0
-100
-200
-300
Without Tax Cut
With Tax Cut
1997
1998
1999
2000
2001
2002
2003
2004


The Unpredicted Surplus
Estimates of surplus/deficit(-) for FY 1998 in billions of dollars
100
0
-100
-200
-300
-400
-500
Jan/Feb 1993
Jan/Feb 1994
Jan/Feb 1995
Jan/Feb 1996
Jan/Feb 1997
Jan/Feb 1998
Actual Oct. 1998
CBO
OMB
Actual


Federal Grants to
State and Local Governments
Dollars in billions
450
425
400
375
350
325
300
275
250
$407
$285
Average annual growth = 9%
Share of state budget grows
from 24% to 27%
2000
2001
2002
2003
2004


Overall Spending Held to Family Income
Presidential Priorities Grow Faster
Percentage growth 2003-2004
12
10
8
6
4
2
0
4.0
4.0
4.2
5.6
7.5
7.6
9.0
10.6
12.3
Global AIDS
Millennium Challenge Account
Famine
Diplomatic & Consular
Foreign Military
Other
Family Income
Budget Total (Discretionary)
Defense
Education
EPA Operating Program
Homeland Security
Nat'l Science Foundation
Veterans Affairs
State & Int'l Assistance


The Deficit and National Priorities
Surplus(+)/Deficit(-) in billions of dollars
100
0
-100
-200
-300
-400
2003
2004
2005
2006
2007
2008
Baseline
Economic Growth Package
Defense and Homeland Security
Education
Veterans
Homeownership
Global AIDS Initiative
Health Care for the Uninsured
Other Priorities

Questions for the Record
2/5 Hearing – Director Daniels Before Senate Budget Committee

Questions from Sen. Byrd

Question: The President's budget devotes a considerable amount of attention to the new Homeland Security Department, but barely mentions its predecessor, the White House Office of Homeland Security.

The only reference to the Homeland Security Office in the President's budget is to request that its appropriation be consolidated with in a single White House appropriation, further isolating the Office's activities from the American public and the Congress.

The OMB Director reviews the budget for the White House Office, which includes the Homeland Security Office, and makes recommendations to the President with regard to that budget. The OMB Director cannot approve the Homeland Security Office's budget without knowing how the Office plans to spend its money.

What are the President's plans with regard to the Office of Homeland Security, and how will that Office's activities differ from what it was doing prior to the creation of a Homeland Security Department? Why is this Office still necessary now that a new Department had been created?

Answer: The President established the Office of Homeland Security to provide support to the Homeland Security Council as constituted by Executive Order 13228 and to develop and coordinate the implementation of a comprehensive national strategy to secure the United States from terrorist threats or attacks. The President announced the National Strategy for Homeland Security in July 2002. The Strategy lays out a prioritized framework for the Federal Government, state and local governments, private sector entities, and citizens to contribute to homeland security. It also provides the vision for the Department of Homeland Security, which consolidates many of the government's homeland security programs and clarifies lines of responsibility and accountability for key homeland security activities, remedying the fragmentation that existed before September 11, 2001.

However, the Department of Homeland Security does not consolidate all homeland security programs; nor can a single Department bear responsibility for coordinating government-wide implementation of the National Strategy for Homeland Security and other Federal Government homeland security policies. Ensuring our Nation's homeland security will still require substantial interagency coordination – between the Department of Homeland Security and the Departments of Defense, State, and Health and Human Services; the FBI and CIA; and other Federal departments and agencies. Accordingly, the Homeland Security Council and its staff continues to coordinate Federal homeland security policy.

Congress recognized the need for continued interagency coordination by establishing in the Homeland Security Act of 2002 the Homeland Security Council to advise the President on homeland security matters and coordinate homeland security policies of the Federal Government. The Act also provides that the Council shall have a staff to support the Council's activities. The President's expectation is that the Homeland Security Council staff at the White House will carry out responsibilities in a manner similar to the staffs of the other policy coordinating councils within the Executive Office of the President.

Question: Director Daniels, in his State of the Union address, the President reiterated his belief that "The best way to address the deficit and move toward a balanced budget is to encourage economic growth."

But even though the Office of Management and Budget is projecting economic growth for 2004 at a healthy 3.6 percent, budget deficits are still projected at $307 billion for that year.

How fast would the economy have to grow to finance the President's budget in each of the Fiscal Years 2004 through 2008?

Answer: The past five years have demonstrated clearly the dramatic impact the economy has on the budget outlook. No one foresaw the surpluses of the late 1990s and no one foresaw the deficit in 2002. The economy was responsible for two-thirds of the change from a $283 billion projected surplus to a $158 billion actual deficit in 2002.

The economy is what produced the surge in revenues in the late 1990s that led to budget surpluses and the economy was the overwhelming reason why the budget is in a deficit today.

Because of uncertainty, the Administration has made a cautious forecast of the budget outlook. While the President's budget includes an aggressive economic and growth package and fully reflects the cost of that package, the economic projections are in line with CBO's baseline projections. After selecting these conservative economic assumptions, the Administration further reduced its receipts forecast for 2003 by $25 billion and for 2004 by $15 billion.

Although both CBO and OMB produce sensitivity analyses of the impact of economic growth on the budget outlook, we cannot project the precise impact of economic growth on the budget outlook with any confidence. While revenue forecasts are always subject to a great deal of uncertainty, they are even more so today following last year's experience when, despite economic growth of 3.3 percent in 2002, revenues declined by 7 percent. It appears that federal revenue collections have become unusually sensitive to fluctuations in the income of higher-income individuals, some of whose compensation is closely tied to the stock market, and these effects are not yet adequately reflected in our tax models. Nevertheless, we believe that as the economy continues to regain its footing and as employment growth begins to accelerate, a more traditional relationship between the economy and receipts will resume. Therefore, strong and sustained economic growth will generate the revenue that combined with spending restraint will produce a balanced budget.

Extending Discretionary Caps and Pay-go Limits

Question: In 1990, I played a central role in negotiating with the Bush Administration on a set of important tools for fiscal discipline. These tools, which were carefully balanced, put limits on discretionary spending and also required that increases in mandatory spending and cuts in revenues had to be paid for. These limits were quite effective in helping to reduce deficits for the period from 1991 to 1997 because they covered all aspects of the budget, taxes, mandatory spending and discretionary spending.

The President's budget proposes to extend the caps in discretionary spending and the so-called pay-go scorecard for two years. Does the President propose to make the pay-go rules apply to his $1.4 trillion of new tax cut proposals?

Answer: The President's Budget proposes to extend the discretionary caps and the pay-as-you-go provisions of the Budget Enforcement Act (BEA) for 2004 and 2005 at the levels proposed in the President's 2004 budget, enforced by sequestration of discretionary spending if the caps are exceeded. The Budget proposes to guarantee that highway excise taxes are made available for obligations and outlays for highways and mass transit programs for 2004 through 2009.

The Administration proposes to extend the requirement that mandatory spending and receipts legislation not increase the deficit or reduce the surplus, enforced by sequestration of mandatory spending. The Pay-As-You-Go (PAYGO) requirements of the BEA would be extended for two years. The Administration proposes to establish a reserve for the tax and mandatory spending initiatives contained in the 2004 budget. To the extent that the President and the Congress agree that the initiative is essential for stimulating economic growth or otherwise addressing urgent national needs, the initiative would be exempt from the PAYGO requirement. OMB would score the effect on the deficit in the budget year and the subsequent four fiscal years of new legislation enacted before October 1, 2005.

Clean Coal Technology Promise

Question: In October of 2000, candidate George Bush came to my state of West Virginia, and, with great fanfare, announced his support of the Clean Coal Technology Program, one of the most successful public-private ventures ever funded by the Congress. IN fact, candidate Bush promised that, if elected, he would commit $2 billion over ten years toward the program; an average of $200 million per year.

In his first budget submission, the Fiscal Year 2002 budget, the President proposed spending $150 million on the Clean Coal program. In the Fiscal Year 2003 budget, the President again proposed spending $150 million. Earlier this week the President submitted his third budget, the Fiscal Year 2004 budget. This time, though, the President has cut Clean Coal funding back to $130 million. That's a $20 million, or 13 percent, reduction.

By my calculations, Mr. Daniels, the President has thus far not kept his commitment to the people of West Virginia to the tune of $170 million. More egregious, though, is the overall effect his backtracking is having on this nation's energy security and our efforts to enhance our energy independence. In case you were not aware, I would just point out that 52 percent of all the electricity generated in this country is generated by a coal-fired power plant. And if we ever hope to reduce our dependence on foreign oil, we are going to need to find better ways or utilizing our own abundant fossil energy resources.

Given there facts – the under funding of the Clean Coal Technology program contrary to what was promised – please tell the Committee how you think the President squares his campaign rhetoric with the reality of his budgets. What should I say to the people of West Virginia when they ask me why the President is not living up to his commitment?

Answer: The FY 2004 Budget provides a total of $321 million for coal research, which continues to meet the President's commitment to spend $2 billion on clean coal research over 10 years. In fact, the President has included a total of $902 million for the President's Coal Research Initiative in his three budgets from 2002-2004, which puts the Administration on a path to greatly exceed the President's commitment. The 2004 Budget is a $5 million increase over the FY 2003 Budget and more than two and one half times as much as the average request from 1995 to 2000.

The 2004 Budget for the President's Coal Research Initiative consists of:

- $130 million for clean coal technology research, development, and demonstration activities in the Clean Coal Power Initiative;
- $82 million for the Central Systems Program to provide the critical research needed to dramatically reduce coal power plant emissions and significantly improve efficiency to reduce carbon emissions;
- $62 million for carbon sequestration research to separate and permanently store (sequester) greenhouse gas emissions from the combustion of fossil fuels, a key part of the strategy to improve coal's viability in the energy supply mix; and
- $47 million for long-term research projects that can potentially contribute to many aspects of the coal research program, including a new program to seek out ways to produce hydrogen from this abundant energy source.

Homeland Security

Question: In the State of the Union Address, the President said, "Whatever action is required, whenever action is necessary, I will defend the freedom and the security of the American people."

The President proposes $28.2 billion for non-Defense homeland security programs under the jurisdiction of the Appropriations Committee. This compares to approximately $26.7 billion in FY 2003 and $24.2 billion on FY 2002. This is barely a robust budget.

Despite having signed authorization bills to significantly increase investments in airport security, port security and border security and despite the fact that the President announced a plan for State and local governments to vaccinate 10 million first responders for a potential small pox attack, the President his included remarkably little funding for this purposes in his budget.

In fact, there is no additional FY 2004 funding requested for the major elements of these authorization bills. There is no funding for port security grants, despite there being over $600 million of eligible applications, no additional funding for airports for security modifications, no additional funding for State and local governments to implement the President's small pox vaccine plan, no special funding to improve security at out nuclear facilities, and only $3 million for the Operation Safe Commerce initiative (to secure containers once they arrive at US ports).

How can the President say that he will do whatever it takes when such basic elements of a homeland security program are not funded in his budget?

Answer: First and foremost, the President's statement is proven by his record. The Administration continues to pursue terrorists throughout the world and bring them to justice. The War on Terrorism is an effort that the Administration is pursuing on many fronts, of which homeland security is one of the most critical.

By any measure, the growth in funding over the levels prior to September 11, 2001 has been dramatic. The funding levels for non-Defense homeland security programs have more than doubled over the pre-9/11 levels. The FY 2004 Budget includes increases over the FY 2003 proposed level for agencies across government, including agencies across government, including the Departments of Homeland Security, Justice, Commerce, Energy, State, the Corps of Engineers, the National Science Foundation, and the Nuclear Regulatory Commission.

Further, the comparison you are making understates real proposals that the President has made to increase the security of our Nation. For example, the President has proposed the Bio-shield Initiative, an $890 million mandatory program that would allow the government to purchase emerging bioterrorism countermeasures more quickly. This program will ensure the government's ability to procure the most advanced countermeasures as they are developed, and is a critical enhancement to the homeland security funding level regardless of the category under which it falls.

Furthermore, the President's FY 2004 Budget includes significant funding in the areas highlighted in your question. For example:

- The FY 2004 Budget includes $829 million request for the Department of Homeland Security's new Information Analysis and Infrastructure Protection Directorate, a $652 million increase (368 percent) over FY 2003, including approximately $500 million to assess the nation's critical infrastructure (e.g., nuclear power plants, ports, and transportation systems) and ensure that the highest priority vulnerabilities are addressed.

- The FY 2004 Budget includes $348 million in the Department of Homeland Security for infrastructure and technology investments along the border and for transportation security including remotely operated infrared cameras to monitor isolated border areas, and radiation detection and x-ray machines for inspecting cargo containers. Further, it provides $62 million for the Container Security Initiative, which ensures that higher-risk cargo containers are inspected before they enter the United States.

- The FY 2004 Budget repeats an over $1.4 billion investment in public health preparedness grants in the Department of Health and Human Services from FY 2003 Budget. These funds are available for a wide array of public health activities, and can be used for smallpox vaccinations.

- The FY 2004 Budget provides $1.4 billion for homeland security activities at the Department of Energy, a 17 percent increase, and $53 million for the Nuclear Regulatory Commission, a 33 percent increase. These agencies are continuing to pursue important enhancements to improve the security of our nuclear facilities and materials.

Additional enhancements to homeland security are discussed in the FY 2004 Budget.

Questions for the Record
2/5 Hearing – Director Daniels Before Senate Budget Committee

Questions from Sen. Tim Johnson

Question: The President has submitted a budget that simply does not add up. The country us facing enormous challenges over the next several years: Rising health care costs, the aging of the baby-boomer generation, increased pressures from abroad and a possible war.

Instead, the President's budget makes irresponsible tax cuts, forecasts deficits as far as the eye can see and greatly increases our national debt. The administration seems to be banking solely on economic recovery to make the deficits disappear.

In particular, the budget adversely affects South Dakota and rural states. There are reductions in transportation and energy programs that help rural areas. Rural economic programs take a huge hit in this budget, including the elimination of rural housing and economic development funding, cuts in clean water and waste disposals systems, as well as reductions in rural loan plans. And there is not still no funding for drought aid, which would provide a greater economic stimulus for my state and the plains than anything proposed by the Administration.

For South Dakota, perhaps the most egregious cut is the sledgehammer that the Administration is applying to existing drinking water projects in my state. Construction of the Mni Wiconi and Mid-Dakota projects are nearly finished after several years of work, but instead, the Administration has proposed severs cuts in funding in the budget.

This is unacceptable. Contrary to what you may think, there are not pork barrel projects, but are projects that will be provide safe drinking water in areas that have had a clean, dependable source of drinking water.

How do you justify these cuts given difficult economic circumstances currently facing rural America?

Answer: The President believes a strong economy will be a great benefit for South Dakota and the rural economy of America. In addition to improving the livelihood of South Dakotans and other Americans, a strong economy provides Washington, D.C. with the resources through tax collections to finance a government that is spending over $2 trillion annually, on programs that range from those to carry out the war against terrorism abroad to water projects in South Dakota.

While federal spending has seen tremendous growth in recent years, the Administration's budget provides an additional increase in spending in this year's budget. However, the President believes that the federal budget should not grow faster than average family budget and has proposed to hold spending in 2004 to an increase of 4 percent.

The funding request for the South Dakota rural water projects mentioned below was reduced as a result of information derived during the Program Assessment Rating Tool (PART) process examining Reclamation's Rural Water Projects. Although OMB did not make recommendations for funding levels for specific projects, we passed back an overall level for all rural water projects; the final allocation between projects was based on Reclamation's recommendations.

Bureau of Reclamation Rural Water Project Funding in North and South Dakota

(dollars in millions)	FY 02	FY 03 Proposal	FY 04 Request	Percent Complete
Mid-Dakota (SD)	13.615	10.040	2.015	68%
Mni-Wiconi (SD)	34.117	31.520	12.971	57%
Lewis & Clark (SD)	1.8	2.0	0	less than 1%
Northwest Area Water System (subset of Garrison Project, ND)	12.410	6.372	0	58%

The justification for reducing funding for these projects is based on several findings: (1) These projects are not part of Reclamation's core mission of delivering irrigation water and hydropower. The large authorization levels and growing funding of these projects over the past several years have cut into core operations. These demands are making it increasingly difficult for Reclamation to manage its already-existing, aging infrastructure; (2) The rural water projects have serious problems regarding project development and performance measures; most project development is done without consulting the agency, and may not represent the best use of taxpayer funds; (3) Non-tribal local cost-share is inadequate; (4) There is significant mission overlap between Reclamation's rural water projects and the rural water programs of other agencies, such as Rural Utilities Service, Indian Health Service, and EPA's Drinking Water State Revolving Fund.

Sen. Domenici – Inserts for the Record

Transcript, p. 98. Could you explain that to us also? I would think this is extending the way we have heretofore treated emergency designation vis-a-vis emergency spending, but I am not quite sure from the summary that that is the case.

Response: The Administration is proposing to insert within Section 250 (which lays out all terms and definitions) of the Budget Enforcement Act (BEA) a definition of an emergency requirement, which is currently not included in the BEA. This definition would state in law what we have said in principle -- that for an item to be declared an emergency, it must be for a purpose that is necessary, sudden, urgent, unforeseen, and temporary in nature.

In addition to officially defining an emergency requirement, the President proposes to clarify in law the necessary steps for a provision to receive emergency status. Under the current process, the Congress would declare a provision or even an entire Title in an Act as an emergency. This left the President with the option of either designating an entire provision or section of an Act as an emergency or not. The President's proposal would require that both the President and the Congress concur that each individual item or direct spending proposal in a provision or Title of an Act be designated as an emergency -- the Congress should do so in statute and the President in a separate message to Congress. This would protect against the "bundling" of non-emergency items with true emergency spending.

Transcript, pps. 98-99. With reference to that category, could you tell us for the record what programs you have suggested for elimination if any, and what programs you suggested should be reduced by more than 5 percent? Might you have one of your analysts tell us comparably, how many programs have been eliminated over the past 5 years that you all know as budgeteers?

Response: We are constantly reviewing programs in the Federal government to ensure program effectiveness and program performance. For example, in the FY 2004 Budget, the Administration proposes no funding for 44 Education Department programs that were funded in 2002. This includes 38 programs proposed for termination in 2003 to redirect $986 million to other more effective programs. In addition, the 2004 Budget proposes the elimination of 6 other programs, freeing up $527 million for higher priority activities.

As background, the Education Department operates about 200 programs and the Administration identified 44 narrow-purpose programs for elimination so that resources can be redirected to higher priority activities that have greater potential for results. These eliminations fall into one or more of the following categories: (1) Duplicative: Many of these activities can be carried out under more flexible State grant programs that allow States and school districts to design programs that best address local needs; (2) No track record of success: there are no objective evaluation data to show that these programs are having a measurable impact on the quality of education; (3) Mission accomplished: Several of these programs achieved the purposes for which they were established and Federal support is no longer needed.

The list of terminations is attached and includes: (1) 21 elementary and secondary education programs authorized in the No Child Left Behind Act last year. These programs are no longer necessary because their purposes can be supported under the broad, flexible State grant programs supporting K-12 education; (2) 6 programs providing technical assistance for elementary and secondary schools and parents. These separate programs provide a fractured response to the technical assistance needs of States and schools and do not consistently employ evidence-based practice; (3) 10 job training programs, including 5 vocational rehabilitation programs and 5 vocational education programs. Many of these terminations are part of a broader Administration plan to reform job training programs and eliminate duplicative or ineffective activities; (4) 7 postsecondary education programs. Two of these have accomplished their mission and the remainder are duplicative or have no track record of success. Programs proposed for termination for the first time in 2004 are noted in italics in the attachments. These include: Comprehensive School Reform, Assistive Technology State Grants, Tech Prep State Grants, Perkins Loans Capital Contributions, Loan Forgiveness for Child Care Providers, and Regional Educational Labs.

Transcript, pps. 102-103. Some are pulled back and thus should not be counted twice. Can you do that for us on a separate account? Can you tell us how much of the taxes are moved forward that were already in place and would have come into effect in the out years?

Response: The effect on receipts of the Administration's economic growth package proposals would be a reduction of $31 billion in FY 2003 and $111 billion in FY 2004. The revenue loss associated with the provisions that are accelerations of reductions scheduled to take place under current law is $23 billion in FY 2003 and $76 billion in FY 2004. Complete information on the economic growth package, including the accelerations, can be found in the *Analytical Perspectives* volume on pages 66-68 and Table 4-3 on page 81.

Department of Education Terminations Proposed in 2004
($$ in Millions)

Program Name	2002 App	2003 Request
Comprehensive School Reform[1]	***235***	***235***
Close Up Fellowships	2	-
Dropout Prevention Programs	10	-
Principal Recruitment	10	-
National Board for Professional Teaching Standards	10	-
National Writing Project	14	-
Preparing Tomorrow's Teachers to Use Technology	63	-
Elementary and Secondary School Counseling	33	-
Smaller Learning Communities	142	-
Javits Gifted and Talented Education	11	-
Star Schools	28	-
Ready to Teach	12	-
Foreign Language Assistance Program	14	-
Carol M. White Physical Education Program	50	-
Community-based Technology Centers	33	-
Exchanges with Historic Whaling and Trading Partners	5	-
Arts in Education	30	-
Women's Educational Equity	3	-
St. Grants for Community Service for Expelled/Suspended	50	-
Alcohol Abuse Reduction	25	-
Rural Education	163	-
Parental Assistance Information Centers	40	-
Eisenhower Regional Math and Science Education Consortia	15	-
Eisenhower Math-Science Clearinghouse	5	-
Regional Educational Laboratories[1]	***68***	***68***
Regional Technology in Education Consortia	10	-
Comprehensive Regional Assistance Centers	28	-
VR Migrant and Seasonal Farmworkers	2	-
VR Recreational Programs	3	-
Projects with Industry	22	-
Supported Employment State Grants	38	-
Assistive Technology State Grants[1]	***24***	***16***
Tech-Prep State Grants[1]	***108***	***108***
Tech-Prep Demonstration	5	-
State Grants for Incarcerated Youth Offenders	17	-
Literacy Programs for Prisoners	5	-
Occupational and Employment Information	10	-
Perkins Capital Contributions[1]	***100***	***100***
Leveraging Educational Assistance Partnership	67	-
Loan Forgiveness for Child Care Providers[1]	***1***	***1***
Demonstration Projects to Ensure Quality Higher Education for Students with Disabilities	7	-
Thurgood Marshall Legal Opportunity Program	4	-
B.J. Stupak Olympic Scholarships	1	-
Underground Railroad Program	2	-
Total BA, Program Terminations	**986**	**527**
Total Count, Program Terminations	**38**	**44**

[1] **Proposed in 2004. Non-add in 2002 Appropriations column.**

Department of Education Terminations Proposed in 2004

Note: Terminations new in 2004 are italicized; FY 2003 Estimates have not yet been updated to reflect what was enacted in the FY 2003 Omnibus Bill

Elementary and Secondary Education:

The No Child Left Behind Act reformed elementary and secondary programs, creating large, flexible State grants and allowing districts to move funds between programs to better serve local priorities. Therefore, most small, narrowly focused K-12 programs are no longer necessary because their purposes can be supported under the State grants programs.

- ***Comprehensive School Reform (CSR).*** *2003 request: $235 million. This program helps turn around failing schools by supporting research-based reform strategies that address all aspects of a school. CSR and a state set-aside in Title I support the same purpose: to improve failing schools through proven reform strategies. In the 2004 Budget, the Title I set-aside for failing schools will be nearly $500 million, more than double the 2003 request for CSR. In addition, high poverty schools can use Title I funds for school-wide reforms. Because CSR is duplicative, its resources are being redirected to Title I to allow troubled schools to carry out reforms without having to apply to a separate grant program. CSR received only an "Adequate" rating on the PART. This rating is based on mixed performance data and lack of evaluation data. Performance data from states show improvements in elementary schools, but not in middle school math or high school reading. These funds will be redirected to Title I.*

- **Close Up Fellowships.** 2002 funding: $1.5 million. This program supports a grant to the Close Up Foundation for awards to teachers and students engaged in professional development or civic responsibility activities. The Administration does not view support of this program as an appropriate Federal responsibility and thus no funds are requested.

- **Dropout Prevention Program.** 2002 funding: $10 million. This program funds drop-out prevention and reentry activities, such as mentoring, counseling, and comprehensive school reform in secondary schools. No funds are requested for this program because these types of activities are currently supported under much larger, more flexible programs including Title I Grants to LEAs, and Innovative Programs State Grants. Continuing this program would only increase program fragmentation and bureaucratic red tape.

- **Principal Recruitment.** 2002 funding: $10 million. This program provides discretionary grants to high-need Local Education Agencies (LEAs) to recruit and retain school principals and assistant principals. No funds are requested for this program because these activities can be carried out, at a State or locality's discretion, through the much larger Teacher Quality State Grants program.

- **National Board for Professional Teaching Standards.** 2002 funding: $10 million. This program provides funding to the National Board for Professional Teaching Standards (NBPTS) for assessing the skills of veteran teachers through a voluntary process for national certification. The Teacher Quality State Grants program allows States and LEAs to use funding for advanced teacher certification. The Administration requests no funds for this program because it diverts Federal funding from States and LEAs for an inflexible purpose that may not be a part of State and local education reform strategies.

- **National Writing Project.** 2002 funding: $14 million. This program supports contracts with non-profits and institutions of higher education to run small teacher training programs on writing. The Administration requests no funds for this program because it is a narrow-purpose program that can be supported without Federal funding.

- **Preparing Tomorrow's Teachers to Use Technology.** 2002 funding: $62.5 million. This program assists consortia of public and private entities in carrying out programs that prepare prospective teachers to use technology to improve student achievement and instructional programs. The Administration requests no funds for this program because it is duplicative. States and localities can undertake these kinds of activities under both the Technology State Grants program and the Teacher Quality State Grants program.

- **Elementary and Secondary School Counseling.** 2002 funding: $33 million. This program provides grants to school districts for the initiation or expansion of elementary or secondary school counseling programs. The Administration requests no funds for this program because it is a narrow-purpose program that diverts funds from State and local reform efforts.

- **Smaller Learning Communities.** 2002 funding: $142 million. This program provides grants to school districts for planning and implementation of schools within schools or other reform strategies intended to reduce school size. The Administration requests no funds for this program because it is a narrow-purpose program that diverts funds from State and local reform efforts.

- **Javits Gifted and Talented Education.** 2002 funding: $11 million. This program provides grants to school districts and institutions of higher education for research, demonstration projects, teacher training, and other activities to help educate gifted and talented students. The Administration requests no funds for this program because it is a narrow-purpose program that diverts funds from State and local reform efforts.

- **Star Schools.** 2002 funding: $27.5 million. This program supports distance education projects to improve instruction in mathematics, science, foreign languages, and other subjects, particularly for underserved populations. The Administration requests no funds for this program because it is a narrow-purpose program without a track record of proven success.

- **Ready to Teach.** 2002 funding: $12 million. This program funds a national telecommunications-based program(s) designed to improve teaching in core curriculum areas. The Administration requests no funds for this program because it is a narrow-purpose program that diverts funds from State and local reform efforts.

- **Foreign Language Assistance Program.** 2002 funding: $14 million. This program provides grants to State Educational Agencies and school districts for programs to establish, improve, or expand foreign language study in elementary and secondary schools. The Administration requests no funds for this program because it is a narrow-purpose program that preempts the State and local flexibility provided through Language Acquisition grants.

- **Carol M. White Physical Education Program.** 2002 funding: $50 million. This program provides grants to school districts and community-based organizations for efforts to initiate, expand, and improve elementary and secondary physical education programs. The Administration requests no funds for this authority because it does not have an adequate accountability infrastructure to ensure quality programs at the local level.

- **Community Technology Centers.** 2002 funding: $32.5 million. This program provides access to computers and technology, particularly educational technology, for adults and children in low-income communities who otherwise would lack that access. The objectives of the Community-Technology Centers program can be supported under the Title II Educational Technology State Grants program, if a State or locality so chooses.

- **Education, Cultural, Apprenticeship, and Exchange Programs for Alaska Natives, Native Hawaiians, and Their Historical Whaling and Trading Partners in Massachusetts.** 2002 funding: $5 million. This program provides grants to organizations to support activities consistent with education, cultural, apprenticeship, and exchange programs for Alaska Natives, Native Hawaiians, and their historical whaling and trading partners in Massachusetts. The Administration requests no funds for this program because it is a narrow-purpose program that diverts funds from State and local reform efforts.

- **Arts in Education.** 2002 funding: $30 million. This program provides grants to a variety of entities for educational reform through strengthening arts education. The Administration requests no funds for this program because it is a narrow-purpose program that diverts funds from State and local reform efforts.

- **Women's Educational Equity.** 2002 funding: $3 million. This program provides grants to a variety of entities for the creation and implementation of model equity programs in schools. The Administration requests no funds for this program because it is a narrow-purpose program that diverts funds from State and local reform efforts.

- **State Grants for Community Service for Expelled or Suspended Students.** 2002 funding: $50 million. This program provides formula grants to States for programs that require students expelled or suspended from school are required to perform community service. The Administration requests no funds for this program because it is duplicative of other programs supported in Safe and Drug Free Schools National Activities. In addition, States can use Safe and Drug Free State Grant funds for community service activities.

- **Grants to Reduce Alcohol Abuse.** 2002 funding: $25 million. This program provides grants to school districts for programs to curb alcohol abuse in secondary schools. The Administration requests no funds for this program because it is duplicative of other programs supported in Safe and Drug Free Schools National Activities. In addition, States can use Safe and Drug Free State Grant funds for alcohol abuse reduction activities.

- **Rural Education.** 2002 funding: $163 million ($81.25 million for Small, Rural School Achievement and $81.25 million for the Rural and Low-Income School program.) Rural Education supports two independent programs: the Small, Rural School Achievement program, and the Rural and Low-Income School Program. The Small, Rural School Achievement program provides funds to eligible rural school districts for purposes consistent with major elementary and secondary State formula grant programs. The Rural and Low-Income School program awards competitive grants to States to support rural school districts. Local activities under the Rural and Low-Income School program are similar to existing major elementary and secondary State formula grant programs. The Administration requests no funds for either program because of duplication with existing State formula grant programs.

Elementary and Secondary Technical Assistance: These six programs are no longer needed because technical assistance activities have been consolidated into the What Works Clearinghouse supported in the Institute of Education Sciences.

- **Parental Assistance Centers.** 2002 funding: $40 million. This program supports centers in most States that offer technical assistance to parents in improving the education of their children, and to school districts to increase parental involvement. No funds are requested for this program since technical assistance activities have been consolidated into the What Works Clearinghouse supported in the Institute of Education Sciences.

- **Eisenhower Regional Math and Science Consortia.** 2002 funding: $15 million. This program provides funds for ten regional consortia to disseminate exemplary mathematics and science education instructional materials. No funds are requested for this program since technical assistance activities have been consolidated into the What Works Clearinghouse supported in the Institute of Education Sciences.

- **Eisenhower Math-Science Clearinghouse.** 2002 funding: $5 million. This program partners with Eisenhower Regional Math and Science Consortia to disseminate math and science instructional materials. No funds are requested for this program since technical assistance activities have been consolidated into the What Works Clearinghouse supported in the Institute of Education Sciences.

- ***Regional Educational Laboratories.*** *2003 request: $68 million. This program supports regional laboratories that conduct applied research, technical assistance, and other activities to promote education reform. Despite long-term investment and funding increases in recent years, the Regional Labs have not consistently provided quality research or technical assistance. No funds are requested for this program since technical assistance activities have been consolidated into the What Works Clearinghouse supported in the Institute of Education Sciences.*

- **Regional Technology in Education Consortia.** 2002 funding: $10 million. This program supports regional centers that carry out information and resources dissemination, professional development and technical assistance. No funds are requested for this program since technical assistance activities have been consolidated into the What Works Clearinghouse supported in the Institute of Education Sciences.

- **Comprehensive Regional Assistance Centers.** 2002 funding: $28 million. This program funds 15 university-based or non-profit centers that offer technical assistance to States, school districts, and schools on such topics as curriculum, assessments, and instruction. No funds are requested for this program since technical assistance activities have been consolidated into the What Works Clearinghouse supported in the Institute of Education Sciences.

Vocational Rehabilitation: Funds are not requested for five Vocational Rehabilitation programs. Three of these programs will be consolidated into the more flexible VR State grants program. The Recreational Programs has limited national impact and its activities can be financed through non-Federal sources. The Assistive Technology State Grants was created a time-limited program and by 2003, all states would have received at least 10 years of funding.

- **Migrant and Seasonal Farmworkers.** 2002 funding: $2 million. This program provides competitive grants to State VR agencies to serve migrant workers with disabilities. In the Budget, this funding is consolidated into the VR State Grant, consistent with the Administration's initiative to reform job training programs and eliminate duplicative and overlapping activities. There is no need for a separate program to help VR agencies serve migrant workers when these individuals are eligible for services under the broader VR State Grants program.

- **Recreational Programs.** 2002 funding: $3 million. This program supports projects that provide recreation and related activities to individuals with disabilities to help them integrate into the general community. The Budget requests no funding for this program because it has very little national impact, and because these projects are more appropriately financed by State and local agencies and by the private sector.

- **Projects with Industry (PWI).** 2002 funding: $22 million. This program supports projects to help individuals with disabilities obtain employment. In the Budget, this funding is consolidated into the Vocational Rehabilitation (VR) State Grant, consistent with the Administration's initiative to reform job training programs and eliminate duplicative and overlapping activities. This program is duplicative of VR State Grants, which serves the same target population. The Budget also explicitly allows State VR agencies to use their own funds to cover PWI grantees' continuation costs.

- **Supported Employment State Grants.** 2002 funding: $38 million. This program provides a separate stream of funding to State Vocational Rehabilitation (VR) agencies to provide supported employment services to individuals with the most significant disabilities. In the Budget, this funding is consolidated into the VR State Grant, consistent with the Administration's initiative to reform job training programs and eliminate duplicative and overlapping activities. While supported employment can be an effective strategy to help individuals with disabilities obtain jobs, it is unnecessary to provide separate funding for these activities.

- ***Assistive Technology State Grants.*** *2003 request: $16 million. The AT State Grant program was created as a time-limited program to help States increase the availability and access to AT devices through changes in laws, regulations and procedures for individuals with disabilities. The authority for the AT State program expires in 2004. By 2003, all states will have received at least 10 years of funding. This program has never been evaluated and the Department of Education has never submitted an annual report to Congress. The protection and advocacy activities previously carried out under the AT program will be funded in 2004 under Education's Protection and Advocacy of Individual Rights program, which already helps individuals acquire and maintain AT devices.*

Vocational and Adult Education: Five vocational education programs are proposed for termination.

- ***Tech-Prep State Grants.*** *2003 request: $108 million. This program provides grants to States to expand "high school-to-college" transition programs with the goal of increasing the number of students who receive degrees in technical fields. The Budget eliminates funding for this program consistent with the Administration's ongoing effort to consolidate various education and job training programs. The PART indicates that the program is duplicative of other federal programs and is not effective in improving student outcomes. Activities under this program will be supported by the Administration's proposed Secondary and Technical Educational State Grants program, funded at $1 billion.*

- **Tech-Prep Demonstration.** 2002 funding: $5 million. This program supports the establishment of "middle college" programs, comprised of 2-years of high school and 2 or more years of higher education or apprenticeship. No funds are requested for this program because it is duplicative of the Administration's proposed Secondary and Technical Educational State Grants program, funded at $1 billion.

- **State Grants for Incarcerated Youth Offenders.** 2002 funding: $17 million. This program makes grants to State correctional agencies to help incarcerated youth obtain literacy and job skills. The Budget eliminates funding for this program, consistent with the Administration's initiative to reform job training programs and eliminate duplicative and overlapping activities. These activities can be supported through other federal programs; in particular, Youth Opportunity Grants and the Administration's proposed Adult Basic and Literacy Education State Grants.

- **Literacy Program for Prisoners.** 2002 funding: $5 million. This program makes competitive grants to State and local correctional education agencies for programs that reduce recidivism by improving "life skills" (e.g., job skills, anger management). No funding is requested for this program because it is duplicative. Several other federal programs, including Youth Opportunity Grants and the Administration's proposed Adult Basic and Literacy Education State Grants, can support these type of activities.

- **Occupational and Employment Information.** 2002 funding: $10 million. This program provides grants to States to provide occupational and employment information (e.g., career counseling) to youth and adults. No funds are requested for this program because it is duplicative of other federal programs; in particular, Vocational Education State Grants and Title I of the Workforce Investment Act and the Administration's proposed Secondary and Technical Education State Grants program.

Postsecondary Education: Seven programs serving postsecondary education are proposed for termination. Two of these have accomplished their mission and the remainder are duplicative or have no track record of success.

- ***Perkins Loans, Capital Contributions.*** *2003 request: $100 million. This program provides school-based loans to eligible undergraduate and graduate students. Loans are made from institutional revolving funds made up of Federal contributions, institutional matching, and school-level collections of outstanding loans. The Budget proposes to eliminate Federal contributions to these revolving funds because the program duplicates the Federal Family Education Loan and Federal Direct Student Loan programs, which already provide affordable loan aid to needy students. The budget will not affect current recipients of Perkins Loans, and will still allow schools to award new Perkins loans. In fact, in FY 2004 institutions will continue to support more than $1 billion in new Perkins Loans.*

- **Leveraging Educational Assistance Partnership (LEAP).** 2002 funding: $67.5 million. LEAP provides grants to states to encourage them to invest in need-based grant assistance for college students. The Administration requests no funds for this program because its mission has been completed. When the program was first authorized in 1972, only 28 states had need-based grant programs. Today, all States have these programs. Moreover, LEAP requires a 1:1 match on the first $30 million appropriated, and 3:1 thereafter. However, in recent years State matching funds have totaled nearly $1 billion, which suggests that States would continue to fund these grant aid programs even if they didn't receive federal funding.

- ***Loan Forgiveness for Child Care Providers.*** *2003 request: $1 million. This program provides loan forgiveness to qualified individuals who earn a degree in early childhood education and work for two full years as a childcare provider in a low-income community. The Budget proposes to eliminate funding for this program because it is not cost effective to administer -- in 2001, for instance, only 76 borrowers received assistance under this program. Eliminating future funding will have no impact on these current recipients.*

- **Demonstration projects to ensure quality higher education for students with disabilities.** 2002 funding: $7 million. This program provides grants to colleges to support technical assistance and professional development for faculty and administrators to help improve the education colleges offer students with disabilities. The Administration requests no funds for this program because it is duplicative. Eligible projects can receive funding under the Fund for the Improvement of Postsecondary Education (FIPSE) and the Research and Innovation program in the Special Education account.

- **Thurgood Marshall Legal Educational Opportunity.** 2002 funding: $4 million. This program is designed to provide minority, low-income or disadvantaged college students with the information, preparation, and financial assistance needed to gain access to and complete law school study. The Administration requests no funds for this program because it is duplicative. Eligible students can receive financial assistance through the Student Financial Assistance programs and academic support through the TRIO – Student Support Services program.

- **B.J. Stupak Olympic Scholarships.** 2002 funding: $1 million. This program provides financial assistance to athletes who are training at the United States Olympic Education Center or one of the United States Olympic Training Centers and who are pursuing a postsecondary education at an institution of higher education. The Administration requests no funds for this program because it is duplicative. Like all other students, students who are also in training can receive aid through the federal Student Financial Assistance programs and the scholarship and fellowship programs in the Higher Education account.

- **Underground Railroad Program.** 2002 funding: $2 million. This program provides discretionary grants to educational organizations that are established to research, display, interpret, and collect artifacts relating to the history of the Underground Railroad. The Administration requests no funds for this program because its mission has been completed. Grants made over the past four years have enabled the grantees to get their projects off the ground and have succeeded in spreading the story and significance of the Underground Railroad to the American people. Support for the Underground Railroad Program was not intended to be a permanent federal responsibility.

Zeroed Out, But Not Terminated:

- **Access to Telework Fund.** 2002 funding: $20 million. The Budget requests no new funding for this program, however it is not a termination. This program, which was part of the New Freedom Initiative, provides competitive grants to States to help individuals with disabilities purchase the equipment necessary so they can telework from home.

- ***Assistive Technology Alternative Financing Program.*** *2003 funding: $15 million. The Budget request no new funding for this program, however it is not a termination. This program has significant unobligated balances ($36.6 million in 2002 and an additional $15 million in the 2003 budget that are available over two fiscal years) and may not be able to absorb new resources in 2004. The Education Department is developing regulations and will conduct a competition for both 2002 and 2003 funds once the regulations are finalized. Because States are required to provide at least 25% matching funds, the 2002 and 2003 funds should provide sufficient resources to support State interest.*

Russ Feingold

Statement by Senator Feingold
February 5 , 2003
Budget Committee Hearing on the President's FY2004 Budget

Mr. Chairman, I thank Director Daniels for taking time to appear before the Budget Committee this morning to lay out the President's budget for the coming fiscal year. I look forward to reviewing his proposals in more detail, but let me note that without endorsing or faulting some of the specifics, I am greatly concerned at the overall direction this budget takes. Compared with the fiscal position of the budget two years ago, this proposal would complete a nearly $8 trillion drop in the 10-year bottom line of the federal government, moving from a projected 10-year unified budget surplus of $5.6 trillion, to a 10-year unified budget deficit of $2.1 trillion. That is absolutely staggering.

According to the materials provided by the Administration, the President's budget will spend every penny of the Social Security surplus and another $300 billion on top of that for the next fiscal year. And over the next five fiscal years, the Administration projects it will spend all of the Social Security surpluses, and more than $1 trillion beyond that.

Mr. Chairman, as bad as those figures are, I should note that they are, if anything, understating the problem. For example, they do not include the cost of a possible war with Iraq, an event that appears increasingly likely, or the long-term cost of stationing troops in that country in the aftermath of a possible war.

Nor does this budget include the much needed reform of the Alternative Minimum Tax. Today, roughly two and a half million taxpayers are subject to the Alternative Minimum Tax. Without some reform, and assuming the 2001 tax cuts are made permanent, in ten years the number of taxpayers subject to that tax will grow to 39 million. There is little doubt that we need to reform the Alternative Minimum Tax, but the President's budget does not include it, and that reform is expensive. According to the Center on Budget and Policy Priorities, the cost of the most modest of the possible relief options the Administration is expected to consider amounts to more than $685 billion through 2013, including interest. That is another $685 billion on top of the several trillion dollars in deficits this budget contemplates.

Mr. Chairman, for the better part of the last two decades, our Nation's leadership has shared an understanding of the importance of responsible budgeting. That understanding has no party label, and was held in common by Republicans and Democrats alike. It was born of an American ethic that we ought to pay for what we get, and look after those who come after us. This budget is not consistent with that shared commitment.

It comes in the wake of possibly the worst fiscal mistake of a generation, but instead of learning from that mistake, this budget only repeats it by proposing yet another unfunded tax cut that will drive up our debt even further. And it does so on the eve of the retirement of the baby boom generation. There are few projections more certain than that the baby boom generation will put an enormous strain on government resources, especially on Social Security, on Medicare, and on the Medicaid long-term care system. At a time when we should be paying down our debt, and setting aside resources to meet the cost of the baby boom retirement, this budget moves in exactly the opposite direction.

Mr. Chairman, this is a grasshopper budget when we should all be ants.

In the State of the Union address, President Bush said: "We will not deny, we will not ignore, we will not pass along our problems to other Congresses, other Presidents, and other generations." But that is exactly what the Administration's budget would do. By greatly increasing an already enormous federal debt, this budget imposes a giant tax increase on our children and grandchildren.

Mr. Chairman, we should reject this proposal. We should refuse to worsen problems for other Congresses, other Presidents, and other generations, and begin the work of balancing the budget.

1) Director Daniels, the President's budget devotes a considerable amount of attention to the new Homeland Security Department, but barely mentions its predecessor, the White House Office of Homeland Security.

The only reference to the Homeland Security Office in the President's budget is to request that its appropriation be consolidated within a single White House appropriation, further isolating the Office's activities from the American public and the Congress.

The OMB Director reviews the budget for the White House Office, which includes the Homeland Security Office, and makes recommendations to the President with regard to that budget. The OMB Director cannot approve the Homeland Security Office's budget without knowing how the Office plans to spend its money.

What are the President's plans with regard to the Office of Homeland Security, and how will that Office's activities differ from what it was doing prior to the creation of a Homeland Security Department? Why is this Office still necessary now that a new Department has been created?

2) Director Daniels, in his State of the Union address, the President reiterated his belief that "The best way to address the deficit and move toward a balanced budget is to encourage economic growth."

But even though the Office of Management and Budget is projecting economic growth for 2004 at a healthy 3.6 percent, budget deficits are still projected at $307 billion for that year.

How fast would the economy have to grow to finance the President's budget in each of the Fiscal Years 2004 through 2008?

Robert C. Byrd

<u>Extending Discretionary Caps and Pay-go Limits</u>

In 1990, I played a central role in negotiating with the Bush Administration on a set of important tools for fiscal discipline. These tools, which were carefully balanced, put limits on discretionary spending and also required that increases in mandatory spending and cuts in revenues had to be paid for. These limits were quite effective in helping to reduce deficits for the period from 1991 to 1997 because they covered all aspects of the budget, taxes, mandatory spending and discretionary spending.

The President's budget proposes to extend the caps on discretionary spending and the so-called pay-go scorecard for two years. Does the President propose to make the pay-go rules apply to his $1.4 trillion of new tax cut proposals?

Clean Coal Technology Promise

Mr. Daniels: In October of 2000, candidate George Bush came to my state of West Virginia and, with great fanfare, announced his support of the Clean Coal Technology Program, one of the most successful public-private ventures ever funded by the Congress. In fact, candidate Bush promised that, if elected, he would commit $2 billion over ten years toward the program; an average of $200 million per year.

In his first budget submission, the Fiscal Year 2002 budget, the President proposed spending $150 million on the Clean Coal program. In the Fiscal Year 2003 budget, the President again proposed spending $150 million. Earlier this week the President submitted his third budget, the Fiscal Year 2004 budget. This time, though, the President has cut Clean Coal funding back to $130 million. That's a $20 million, or 13 percent, reduction.

By my calculations, Mr. Daniels, the President has thus far not kept his commitment to the people of West Virginia to the tune of $170 million. More egregious, though, is the overall effect his backtracking is having on this nation's energy security and our efforts to enhance our energy independence. In case you were not aware, I would just point out that 52 percent of all the electricity generated in this country is generated by a coal-fired power plant. And if we ever hope to reduce our dependence on foreign oil, we are going to need to find better ways or utilizing our own abundant fossil energy resources.

Given these facts -- the under funding of the Clean Coal Technology program contrary to what was promised -- please tell the Committee how you think the President squares his campaign rhetoric with the reality of his budgets. What should I say to the people of West Virginia when they ask me why the President is not living up to his commitment?

Homeland Security

In the State of the Union Address, the President said, "Whatever action is required, whenever action is necessary, I will defend the freedom and security of the American people."

The President proposes $28.2 billion for non-Defense homeland security programs under the jurisdiction of the Appropriations Committee. This compares to approximately $26.7 billion in FY 2003 and $24.2 billion in FY 2002. This is hardly a robust budget.

Despite having signed authorization bills to significantly increase investments in airport security, port security and border security and despite the fact that the President announced a plan for State and local governments to vaccinate 10 million first responders for a potential small pox attack, the President has included remarkably little funding for those purposes in his budget.

In fact, there is no additional FY 2004 funding requested for the major elements of these authorization bills. There is no funding for port security grants, despite there being over $600 million of eligible applications, no additional funding for airports for security modifications, no additional funding for State and local governments to implement the President's small pox vaccine plan, no special funding to improve security at our nuclear facilities, and only $3 million for the Operation Safe Commerce initiative (to secure containers once they arrive at US ports).

How can the President say that he will do whatever it takes when such basic elements of a homeland security program are not funded in his budget?

QUESTION FOR MITCH DANIELS, 2/5/03 BUDGET COMMITTEE HEARING

Mr. Daniels, the President has submitted a budget that simply does not add up. The country is facing enormous challenges over the next several years: Rising health care costs, the aging of the baby-boomer generation, increased pressures from abroad and a possible war.

Instead, the President's budget makes irresponsible tax cuts, forecasts deficits as far as the eye can see and greatly increases our national debt. The Administration seems to be banking solely on economic recovery to make the deficits disappear.

In particular, the budget adversely affects South Dakota and rural states. There are reductions in transportation and energy programs that help rural areas. Rural economic programs take a huge hit in this budget, including the elimination of rural housing and economic development funding, cuts in clean water and waste disposals systems, as well as reductions in rural loan plans. And there is not still no funding for drought aid, which would provide a greater economic stimulus for my state and the plains than anything proposed by the Administration.

For South Dakota, perhaps the most egregious cut is the sledgehammer that the Administration is applying to existing drinking water projects in my state. Construction of the Mni Wiconi and Mid-Dakota projects are nearly finished after several years of work, but instead, the Administration has proposed severe cuts in funding. And two newly authorized projects, Lewis and Clark and Perkins County are receiving no funding in the budget.

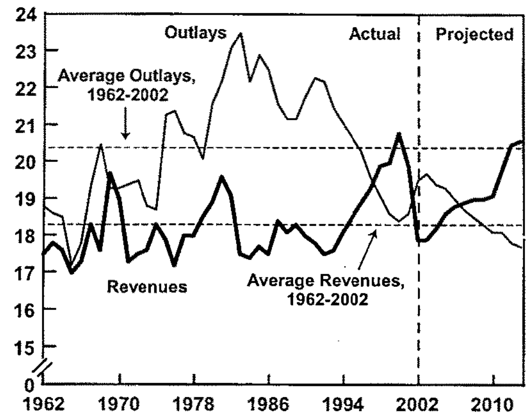
This is unacceptable. Contrary to what you may think, these are not pork barrel projects, but are projects that will be provide safe drinking water in areas that have never had a clean, dependable source of drinking water.

How do you justify these cuts given the difficult economic circumstances currently facing rural America?

Figure 1.

Total Revenues and Outlays as a Share of GDP, 1962-2013

(Percentage of GDP)



Sources: Congressional Budget Office (projections); Office of Management and Budget (historical budget data).

Note: CBO's projections incorporate the assumption that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

as a result of slower growth in enrollment, smaller increases in payment rates, and restrictions on certain types of spending.

Declining interest payments will offset some of the increases in discretionary and mandatory outlays. Despite a rise in debt held by the public, low interest rates in 2003 are projected to reduce net interest payments by $14 billion (or 8.1 percent).

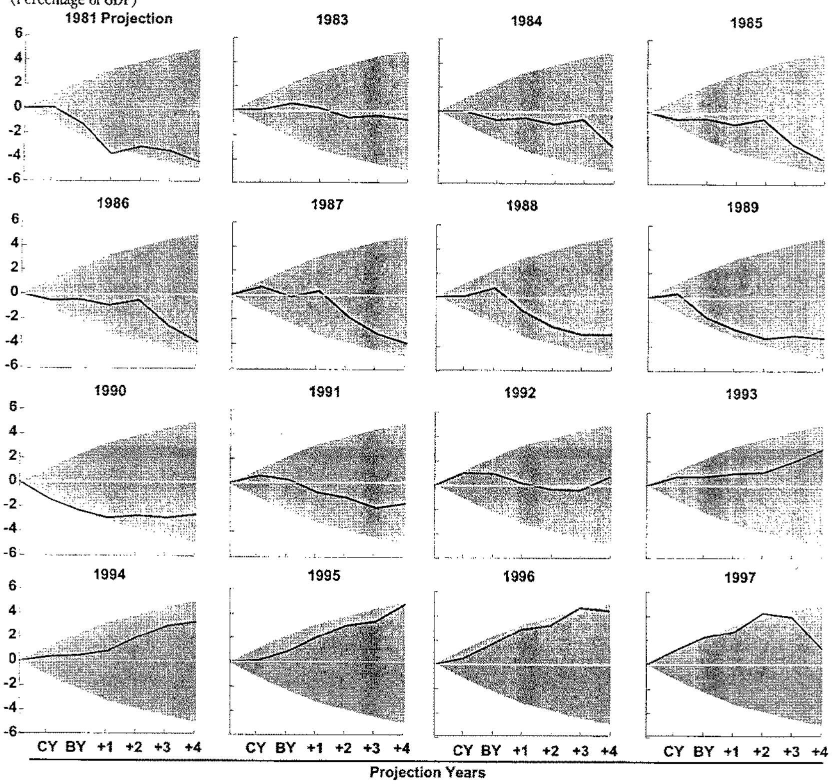
CBO projects that the deficit will fall to $145 billion (1.3 percent of GDP) in 2004. Revenues are anticipated to climb to 18.2 percent of GDP as economic recovery progresses. Outlays as a share of the economy, however, are projected to fall from 19.7 percent of GDP in 2003 to 19.4 percent in 2004.

Over the full 10-year budget period (2004 through 2013), revenues under baseline assumptions are estimated to grow faster than outlays. CBO projects that revenues will grow at an average annual rate of 6.3 percent through 2010—increasing from 17.9 percent of GDP in 2003 to 19.1 percent in 2010. That increase occurs principally because of the tendency of the progressive U.S. tax system, as real income grows, to increase the proportion of income that it collects in taxes. After 2010, that tendency is exacerbated by the scheduled expiration of the tax cuts enacted in 2001.

Figure 3.

Misestimates in CBO's Projections Made from 1981 to 1997

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: CY = current year; BY = budget year.

This figure shows misestimates in CBO's projections of the primary surplus—the total surplus excluding net interest—made at different times. Plotted points that lie below the center line reflect instances in which CBO overestimated the primary surplus, while points above the center line reflect underestimates. In each panel, the shaded cone indicates the estimated 90 percent confidence band; that is, there was a 90 percent chance that CBO's projection would be within the shaded area. CBO estimated that confidence band on the basis of its track record since 1981 (excluding 1982, because of insufficient data).

The figure excludes the effects of legislation enacted after the projections were made.

Uncertainty of Budget Projections

As discussed earlier, significant uncertainty surrounds CBO's baseline projections, partly by design—CBO's baseline does not take into account potential legislative changes—and partly because of the impossibility of accurately forecasting future geopolitical outcomes.

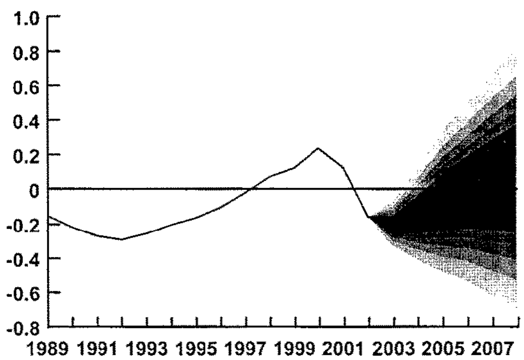
In addition, much uncertainty stems from the fact that the U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to foresee. That uncertainty can best be illustrated by a fan of probabilities surrounding the year-by-year point estimates presented in this testimony (*see Figure 2*). Not surprisingly, the range of possible outcomes widens as the projection period extends. The fan chart makes clear that outcomes quite different from those in our baseline have a significant likelihood of occurring.

We can also use the fan chart methodology to examine whether CBO's projections have been consistently biased in one direction or the other (*see Figure 3*). As the figure shows, CBO's misestimates

Figure 2.

Uncertainty of CBO's Projections of the Total Budget Surplus Under Current Policies

(In trillions of dollars)



Source: Congressional Budget Office.

Note: Calculated on the basis of CBO's track record, this figure shows the estimated likelihood of alternative projections of the surplus under current policies. CBO's projections fall in the middle of the darkest area. Under the assumption that tax and spending policies do not change, the probability is 10 percent that actual surpluses or deficits will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

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

For an explanation of how CBO calculates the probability distribution, see *Uncertainties in Projecting Budget Surpluses: A Discussion of Data and Methods* (February 2002), available at www.cbo.gov; an update of that publication will appear shortly.

THE PRESIDENT'S INTERNATIONAL AFFAIRS BUDGET

TUESDAY, FEBRUARY 11, 2003

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. Don Nickles (chairman of the committee) presiding.

Present: Senators Nickles, Gregg, Allard, Enzi, Sessions, Bunning, Crapo, Ensign, Cornyn, Conrad, Hollings, Murray, and Stabenow.

Staff present: Hazen Marshall, staff director; and Roy Phillips, senior policy analyst.

For the minority: Mary Ann Naylor, staff director; and Dakota Rudisell, analyst.

OPENING STATEMENT OF CHAIRMAN DON NICKLES

Chairman NICKLES. The Budget Committee will come to order. Today we will hear testimony from Colin Powell, Secretary of State. I think everyone is well aware that the Secretary is one of the most distinguished and accomplished individuals in the country, as a professional soldier, as Chairman of the Joint Chiefs of Staff, and presently as Secretary of State.

Mr. Secretary, we welcome you to this Committee, compliment you for your leadership. I complimented you in private for your presentation before the United Nations last week. That was a superb presentation; well documented, well presented, forceful case, so I compliment you for that. Today we look forward to hearing from you on a variety of issues, budget and other issues confronting and challenging our country today.

First I will call upon my colleague, Senator Conrad, if he has any opening comments before I proceed.

OPENING STATEMENT SENATOR CONRAD

Senator CONRAD. Thank you, Mr. Chairman, and special thanks to you for holding this hearing. Special thanks to you, Mr. Secretary, for being here. As an American I would just like to say how proud I was of the presentation that you made and the way you conducted yourself. I think it makes us all proud.

I think no one should doubt that the Congress of the United States will provide the resources necessary to defend this Nation and protect American interests. There should be no doubt about that in anyone's mind. That if war comes, America will stand as one. With that said, I have just returned from my home State and I thought I would share with you, Mr. Secretary, the questions that I am receiving. As I spent time in North Dakota, people came to me and asked me questions, asked me why we are not doing certain things, why we are doing others. Let me just give you a sampling of what I heard, and perhaps you could address it as you move through your remarks.

One question I receive frequently, perhaps more frequently than I have any others, is: Why doesn't containment work with respect to Iraq? I know the President has said that he believes containment is no longer viable after the attack of September 11th. People have asked me—they can see why it wouldn't work with a terrorist organization because there is no country to retaliate against. But in the case of a nation state, why doesn't containment work as it did against the Soviet Union?

To extend this, Morton Halperin has a piece in this morning's Washington Post arguing that containment has worked with respect to Saddam Hussein, that he has not attacked anybody since 1991, and raises the question why it can't continue. That is a question I have received frequently.

Second, and, again, a frequent question is: Why the difference in policy toward North Korea and Iraq? The question that has been put to me is that Korea is developing nuclear weapons, perhaps already has some, has kicked out the inspectors and warned that they may launch a pre-emptive attack against us. But we say there is no crisis with respect to Korea, that it can be solved diplomatically. But in the case of Iraq, where they have inspectors and they have not yet discovered evidence of a nuclear capability, we are prepared to launch a war against them.

A third frequently asked question is the terrorist threat against the United States. In my meetings at home this last weekend, I was asked: Senator, isn't our top priority still Osama bin Laden and Al-Qaeda? Aren't they posed to attack us again? Aren't we diverting our attention by focusing on Iraq first?

A final question I would put to you that has been raised to me, most recently yesterday morning in a meeting with a businessman that does substantial business overseas, and with other businessmen who have been in my office in the last 10 days, saying that they are facing an increasing tide of anti-American sentiment. That, too, was talked about in this morning's paper in an article headlined, "Sneers From Across the Atlantic: Anti-Americanism Moves to West Europe's Political Mainstream," and a second story on the front page, "U.S.-Europe Rifts Widen Over Iraq."

I found a really rising tide of concern back home about this question. One man that I had breakfast with yesterday was saying that he is increasingly concerned about the anti-American sentiment he is finding in business dealings overseas.

Those are kind of a grouping of questions that I am receiving most frequently, and I would be very interested in your take on all of that.

Chairman NICKLES. Mr. Secretary, unless other colleagues have remarks, welcome to the Committee. Thank you.

STATEMENT OF HON. COLIN L. POWELL, SECRETARY, UNITED STATES DEPARTMENT OF STATE

Secretary POWELL. Thank you very much, Mr. Chairman, and I thank you also, Senator Conrad, for your opening remarks, and I will get to all of those questions in the course of my opening remarks.

Mr. Chairman, I do have a statement for the record and would like to submit it at this time and then go to a shortened presentation. At the end of this shortened presentation, I will talk to the questions raised by Senator Conrad.

Mr. Chairman, members of the Committee, I am pleased to appear before you to testify in support of the President's international affairs budget for fiscal year 2004. Funding requested for fiscal year 2004 for the Department of State, USAID, and other foreign affairs agencies is $28.5 billion.

Let me say at this point, Mr. Chairman and members of the Committee, how deeply appreciative I and all of my colleagues in the Department of State and USAID are for the support that this committee has provided to us during the last 2 years, the first 2 years of the Bush administration; and it has been a source of real encouragement to the people of the Department to know that we are making the case to the Congress that we need this kind of support, we are deserving of this kind of support, but, more importantly, we are receiving the support we need to take the case of the American people out to the world and to support our diplomats who are on the front line of offense with respect to our foreign policy and to taking the American case to the people of the world. In light of what Senator Conrad said, never has it been more important for us to be giving that kind of support to our diplomatic efforts across the world.

Mr. Chairman, the President's budget of $28.5 billion will allow the United States to: First, target security and economic assistance to sustain key countries supporting us in the war on terrorism and helping us to stem the proliferation of weapons of mass destruction;

Launch the Millennium Challenge Account—a new partnership generating support to countries that rule justly, invest in their people, and encourage economic freedom;

Strengthen the U.S. and global commitment to fighting HIV/AIDS and alleviating humanitarian hardships;

Next, combat illegal drugs in the Andean Region of South America, as well as bolster democracy in one of that region's most important countries, Colombia; and

Finally, reinforce America's world-class diplomatic force, focusing on the people, places, and tools needed to promote our foreign policies around the world.

I am particularly proud of that last goal, Mr. Chairman, because for the past 2 years I have concentrated on each of my jobs—first, as primary foreign policy adviser to the President, but also as chief executive officer of the Department. Under my CEO hat, we are asking for about $8.5 billion within that $28.5 billion for the running of the Department.

Let me give you some highlights of what these funds are for. First, we have been reinforcing our diplomatic force for 2 years and will continue in fiscal year 2004. We will hire 399 more professionals to help the President carry out the Nation's foreign policy. This hiring will bring us to the 1,100-plus new foreign and civil service officers we set out to hire over the first 3 years of the Bush administration to bring the Department's personnel back in line with its diplomatic workload.

For a period during the 1990's, we were not hiring anyone, foreign service or civil service. We were not administering the foreign service exam. It was a very unfortunate period for the Department. New blood wasn't being brought into the Department. If you want to have a career Ambassador 15 years from now, you have got to hire one today. If you want to have the right kinds of people in your embassies years from now, you have got to hire them today. It is the same concept that I followed when I was Chairman of the Joint Chiefs of Staff. If you want a great battalion commander 15 years from now, you have got to bring in a second lieutenant now. If you want squad leaders to lead young Americans in battle 6 or 7 years from now, you have got to bring in a private now.

We shortchanged the Department, and it has been my No. 1 priority to fix that problem by bringing in wonderful young people who want to serve their Nation as diplomats or as civil servants within the Department of State. I am proud of what we have been able to do. Over the last 2 years, we have administered the foreign service written exam to some 80,000 Americans who stepped forward and said, "I want to be part of this operation." This is multiples of what we have been able to do in past recent years before this administration came in. On the last Foreign Service written exam that was administered some 38 percent of the people who passed the exam were minorities. So we are diversifying our work force. We are making the Foreign Service increasingly look like America, and, frankly, look like the rest of the world. That sends a powerful signal to the rest of the world, because there is no point in my giving these exams and encouraging people and reaching out to the minority community to come and apply if I can't hire them at the end of the day. So I thank the Congress and especially the members of this Committee for the support you have provided to that Diplomatic Readiness Initiative.

Second, I promised the employees of the Department that we would bring state-of-the-art communications, information, and technology capabilities to the Department, because people who can't communicate rapidly and effectively in today's globalizing world can't carry out our foreign policy. We are approaching our goal in that regard as well.

For example, when I spoke at the U.N. last week, within minutes after my speech was finished we were transmitting it in all sorts of different languages to every point on the face of the earth. All of our embassies were getting in real time information on the speech, the visuals and backup materials that I used, so that our Ambassadors could immediately go out and explain our position around the world.

As I have discussed with my staff the morning after my speech, one of the most impressive things about the speech was the audience and the size of the audience listening to it, all in real time. There was one picture in one of the newspapers—I forget whether it was the New York Times or the Washington Post—of a group of

Marine aviators sitting on an aircraft carrier in their ready seats, looking at the screen, and there I was on the screen. It kind of snapped me back.

The point is they are not waiting for somebody to write the story. They are not waiting for one of the learned talking heads to tell them what they should have heard or seen or analyzed. They were watching me in real time, instantaneously. So, increasingly, knowledge and information is being communicated directly to consumers instantaneously. We all know this phenomenon. Call it what you will: 24/7, CNN, Fox, MSNBC, you name it, radio, instant wire service information. But that is the way we communicate to the world right now, instantaneously, directly to the consumer. We have to make sure that that information technology is also available to all of our diplomats, all of our embassies, every action officer, every desk officer everywhere in the Department of State. So I will not be satisfied until every employee of the Department of State at every one of our 260 installations around the world have instantaneous access to the Internet and to the world of modern communications. With your support, we are going to make that happen.

It goes to one of the points that Senator Conrad made earlier: getting the message out and dealing with anti-Americanism when we find it by getting out our product and our message as fast as possible. The daily message line that is coming out of our new strategic communications operation run from the White House, that daily message sheet I am now having distributed to every single embassy, every single facility around the world as soon as we get it from the White House and add our own product to it. We are not sitting around punching up cables on telefax machines anymore. Scan it and send it, and let's get going, let's get it out there, and let's expect our people to know what we know here in Washington as fast as we know it. As I say to all of my Ambassadors, I want you to use it coming back the same way. You are my experts; you are my battalion commanders. Tell me what is going on out in those countries. I am counting on you, not just the expert within the Department on C Street. This information technology knits us all together. We have a first-class, world-class website now that gets more and more hits every single day. We are trying to make it more lively, more interesting to people.

Ambassador Boucher, my Spokesman, is here. He is the face of the Department of State as you see him brief every day. But I told him I am tired of seeing his face on the website. It is either my face or his face on the website. Usually it is his face more than my face, which is also disturbing. [Laughter.]

Secretary POWELL. I told him I didn't want to see either one of our faces on the website. I want to see our diplomats. I want to see the people who work for us. I want to see exciting, different things that are happening around the world. I want people to go to that website and see the central font of knowledge about what is going on in the world, presented to you by your Department of State. So let's put the kids that we bring in to mentor on the website. Let's put what one of our Ambassadors is doing to help people in need in a particular country. But let's mix it up. Let's make it lively. Let's use information technology to take America's story to the world, not as a lecturing way of taking our story to the world but just showing who we are, what we stand for, how we care about the world, talking about HIV/AIDS, talking about poverty, talking about the need to feed people throughout the world these days, and taking that value system through the power of information technology. But I need the money to do it, and I thank this Committee and I thank the Congress for supporting me in that effort.

Finally, with respect to my CEO role, I wanted to sweep the slate clean and completely revamp the way we construct our embassies and other overseas buildings, as well as improve the way we secure those buildings. In turn, this will secure the men and women who occupy them and take care of their family members in our embassies around the world. It is dangerous business out there. I lost three members of our State Department family last year. We put them in danger, and we have an obligation to protect them to the best of our ability.

I think when I first took over as Secretary of State, and during some of my transition discussions with members of this Committee, we had extensive discussions about how to build embassies, how to build them cheaper, how to build them better, how to make sure the system was efficient. We want to make sure we are not wasting the taxpayers' dollars, but make sure we are doing it right.

I am very pleased at what we have been able to accomplish over the last 2 years. General Chuck Williams, whom you have heard me brag about before this Committee, is in charge of our overseas building program. He and his team are doing a great job in getting the costs down and rationalizing our entire management structure for overseas building facilities. I think we have a good record to present to the Committee, and I know the Committee has followed this very, very closely as well. I am pleased that we have gotten on top of that situation.

Mr. Chairman, as principal foreign policy adviser, my other hat for the President, and principal hat, I have budget priorities in that portfolio as well. Let me highlight our key foreign policy priorities before I stop and take your questions. While I am talking about foreign policy, I want to ask the members of this committee for their strong support, and I hope you will all find your way clear to vote for the Moscow Treaty that is now out of committee and will be on the floor in the very near future. I would sure like to see a 100-0 vote for that treaty. It is a good treaty. It serves the interests of the American people as well as the people of the Russian Federation and, I believe, the world.

Mr. Chairman, the 2004 budget proposes several initiatives to advance U.S. national security interests and preserve American leadership. The 2004 Foreign Operations budget that funds programs for the Department of State, USAID, and other Foreign Affairs agencies is $18.8 billion of the $28.5 billion total. Today, our No. 1 priority is to fight and win the global war on terrorism. The budget furthers this goal by providing economic, military, and democracy assistance to key foreign partners and allies, including $4.7 billion to countries that have joined us in the war on terrorism. Of this amount, the President's budget provides $657 million for Afghanistan, $460 million for Jordan, $395 million for Pakistan, $255 million for Turkey, $136 million for Indonesia, and $87 million for the Philippines.

In Afghanistan, the funding will be used to fulfill our commitment to rebuild Afghanistan's road network. In addition, it will establish security through a national military and national police force, establish broad-based and accountable governance through democratic institutions and an active civil society, ensure a peace dividend for the Afghan people through economic reconstruction, and provide humanitarian assistance to sustain returning refugees and displaced persons. United States assistance will continue to be coordinated with the Afghan Government, the United Nations, and other international donors.

Now, that is bureaucratic language. The reality is we have done one heck of a job in Afghanistan. But the problems are not all behind us, and it is still a fragile situation. But we can be very proud of the fact that over the last 16 or 18 months we have now seen the government take over, getting ready for the election next year. We have seen a National Army start to form, and this morning I was reading through my briefing materials how these battalions that were trained are now starting to go to other parts of the country outside of Kabul and starting to make their presence known, starting to put the imprint of the central government on the rest of Afghanistan. A National Police force is being brought up. A judicial system is slowly being created. Institutions are being formed. The road is under construction. It is not just a road, it is more than a road. It is a line of communication that allows the exertion of central control over other parts of the country. Because there is a road, commerce will flow and people will be able to get around. Displaced people, refugees coming back into the country can now move. So, all sorts of good things will happen with this road.

However, there are still dangers in Afghanistan. Operation Enduring Freedom will continue to go after Al-Qaeda and Taliban remnants. But, we have accomplished a great deal, and we should be proud of the work that we have done working alongside coalition members, working alongside ISAF, and working alongside United Nations organizations. A great deal has been accomplished. You can see it in the eyes of the children who are now being educated, and you can see it in the eyes of women, who are now playing a role in the life and in the future of Afghanistan.

Mr. Chairman, I also want to emphasize our efforts to decrease the threats posed by terrorist groups, rogue States, and other nonstate actors with regard to weapons of mass destruction and related technology. To achieve this goal, we must strengthen partnerships with countries that share our views in dealing with the threat of terrorism and resolving regional conflicts. The 2004 budget requests $35 million for the nonproliferation and disarmament fund, more than double the 2003 request. It increases funding for overseas export controls and border security to $40 million and supports additional funding for science centers and bio-chem redirection programs.

Funding increases requested for these programs will help us prevent weapons of mass destruction from falling into the hands of terrorist groups or States by preventing their movement across borders and by destroying or safeguarding known quantities of weapons or source material, especially in the Russian Federation, former Soviet Union.

The science centers and bio-chem redirection programs support the same goals by engaging former Soviet weapons scientists and engineers in peaceful scientific activities, providing them an alternative to marketing their skills to States or groups of concern, give them a healthy, positive alternative and keep them from thinking in any way about going to those States or those non-state actors who might be working on weapons of mass destruction.

The budget also promotes international peace and prosperity by launching the most innovative approach to U.S. foreign assistance in more than 40 years. The new Millennium Challenge Account, an independent government corporation funded at $1.3 billion, will redefine what development aid is all about. As President Bush recently told African leaders meeting in Mauritius, this aid will go to nations that encourage economic freedom, that root out corruption, and that respect the rights of their people. Moreover, this budget offers hope and a helping hand to countries facing health catastrophes, poverty, and despair, those countries who are suffering from the effects of humanitarian disasters.

The budget includes, in addition to the other things I have talked about, more than $1 billion to meet the needs of refugees and internally displaced persons. The budget also provides more than $1.3 billion to combat the global HIV/AIDS epidemic. The President's total budget for HIV/AIDS is $2 billion, which includes the first year's funding for the new emergency plan for HIV/AIDS relief announced by the President in his State of the Union Address. These funds will target 14 of the hardest-hit countries in Africa and the Caribbean.

This budget also includes almost half a billion dollars for Colombia. This funding will support Colombian President Uribe's unified campaign against terrorists and the drug trade that fuels terrorist activity. The aim is to secure democracy, extend security, and restore economic prosperity to Colombia and prevent the narcoterrorists from spreading instability to the broader Andean Region.

To accomplish this goal requires more than simply funding for Colombia. Therefore, our total Andean Counterdrug Initiative is $731 million. Critical components of this effort include resumption of the Airbridge Denial program to stop internal and cross-border aerial trafficking in illicit drugs, stepped-up eradication and alternative development program efforts, and technical assistance to strengthen Colombia's police and judicial institutions.

Mr. Chairman, members of the Committee, to advance America's interest around the world, we need the dollars in the President's budget for fiscal year 2004. We need the dollars under both of my hats, CEO and principal foreign policy adviser. The times we live in are troubled, to be sure, as was noted earlier. I believe there is every bit as much opportunity as there is danger in the days ahead. American leadership is essential with both the danger and the opportunity.

With regard to the Department of State, the President's fiscal year 2004 budget is crucial in order for us to exercise the leadership that will deal with the dangers and the opportunities.

Before closing, Mr. Chairman, I would like to pause and comment to some extent on the issues raised by Senator Conrad.

First, with respect to Iraq, why doesn't containment work? Containment is a strategy that we have followed for many, many years. I have been an advocate of containment. I worked very hard in the first year and a half of this administration to put in place smart sanctions, another form of containment. Yet we found that even with all of these containment efforts of the past 12 years, they have not served to stop Saddam Hussein in his pursuit of weapons of mass destruction or to encourage him to get rid of the weapons of mass destruction that we know he has. Notwithstanding all our efforts at containment, we see evidence that he continues to try to break out of the box. Containment was able to control some of the money that is going to the regime through the Oil for Food Program, but he is still able to get additional money through smuggling and illicit activities activities across the borders of neighboring States. What really brought this all home to roost, that we couldn't just rely on containment, was after 9/11 we see these non-state actors, terrorist organizations, Al-Qaeda, bin Laden, others, terrorists that are trying to develop weapons of mass destruction, seek weapons of mass destruction.

This morning it was brought home to me once again when I read the transcript of what bin Laden, or who we believe to be bin Laden, will be saying on Al-Jazeera during the course of the day. You will be seeing this as the day unfolds, where once again he speaks to the people of Iraq and talks about their struggle and how he is in partnership with Iraq. This nexus between terrorists and States that are developing weapons of mass destruction can no longer be diregarded and ignored.

As the President has said, 9/11 changed things, and so we have a regime led by Saddam Hussein who has not accounted for all the weapons of mass destruction they have had in the past, and who continues to pursue them. We have non-state terrorist actors such as Al-Qaeda, led by Osama bin Laden, that would do anything to get their hands on this kind of material. As I tried to demonstrate before the United Nations last week, there are linkages. They are not as firm as some would like to see in order to conclude that it is actually happening. However, they are firm enough to give us every indication and sufficient evidence that if allowed to continue, if this regime was allowed to continue to develop weapons of mass destruction, it is just a matter of time before coincident interests between the Iraqi regime and organizations such as Al-Qaeda will raise the likelihood that these kinds of weapons could fall into their hands. It is that nexus, especially in the post-9/11 environment, that persuades us even more that this is the time to deal with this regime once and for all.

This is not just the isolated view of the United States of America. We brought this case to the Security Council last September 12th when the President, in response to people all over the world saying if you have a case, bring it to the Security Council, bring it to the United Nations. The President did just that. He didn't act unilaterally. He came to the Security Council and made the case that Saddam Hussein, notwithstanding containment, after 12 years was still in clear violation of his obligations. Then the President charged me to work with the Security Council to come up with a strong resolution that would be a different resolution, not like all of the previous 16, a resolution that had teeth.

We worked for seven and a half weeks on that problem, and we came up with a resolution, 1441, that was unanimously agreed to by every member of the Security Council that was sitting there on the morning of the 8th of November. That resolution clearly says: first, Iraq is guilty, you have been doing this, you are in material breach. All of us agreed on that morning that Iraq continued to be in material breach of its obligations, meaning it was guilty of having weapons of mass destruction, of not having accounted for the anthrax, for the botulinum toxin, for the missiles, for all the other programs, for the nuclear program, all the other things they have been doing. We all agreed.

The second thing the resolution said was we are giving you one last chance—one last chance to come into compliance, one last chance. Not one of ten more chances. One last chance. Put forward a declaration in 30 days that tells us everything you have been doing. Make sure it is complete, full, and accurate. All 15 members voted for Iraq to put forward such a declaration. Then it said we are going to provide a rigid inspection regime, not to play detective running all over Iraq looking for these things, but to work with you in disarming. The obligation and the burden is on Iraq, not on the inspectors. Finally, we said if you fail to put forward a full, complete, and accurate declaration and if you do not cooperate with the inspectors in helping you to disarm, then this will constitute further evidence of your unwillingness to comply, your ignoring of the will of the international community. New material breaches to pile on top of old material breaches, and at that point, the Security Council has a responsibility to meet again to consider what serious consequences might be appropriate.

We are reaching that moment. We are reaching the moment when the Security Council can no longer look away. The inspectors have reported to the Council on the 27th of January that Iraq was only providing passive cooperation. Dr. Blix said on the 27th of January that Iraq still does not yet understand as of that day that its obligation was to disarm. Dr. Blix and Dr. Elbaredi have now returned from Iraq on their weekend trip, and they will be reporting to the Council this Friday. We all anxiously await their report. There are some on the Security Council, there are some in the international community, who are saying, well, we just need more monitors. Dr. Blix dealt with that yesterday. When asked about it, Dr. Blix said—not Colin Powell, not President Bush—Dr. Blix said we don't need more monitors and inspectors, we need Iraq compliance and cooperation. That is the issue, not more inspectors, not more technical means. All the technical means and all the inspectors in the world aren't the answer. The answer is Iraqi compliance, Iraqi full, active, complete cooperation. If we had that, we could probably do with fewer inspectors because we would not be running around looking for needles in haystacks. The haystacks would be brought before the inspectors and peeled apart to show you where the needle is or where the needle was and what happened to the needle that used to be there. That is not what we are getting from Iraq.

So while this debate continues—and it is a very vigorous debate, a debate with some of our best friends and allies—reasonable people can argue and debate over this issue. But it is clear that a moment of truth is coming with respect to Iraq and with respect to the Security Council as to whether it will meet its responsibilities.

This is not just some academic exercise or the United States being in a fit of pique. We are talking about real weapons. We are talking about anthrax. We are talking about botulinum toxin. We are talking about nuclear weapons programs. We are talking about chemically-filled bombs that are missing, and that Iraq has not accounted for.

We are talking about evidence that came from Iraq. They acknowledged and admitted under duress; after pressure was applied to them; after the truth was put in front of their face. They acknowledged that these systems existed. They have not accounted for them.

The United States will not look away from this challenge. Guess what? Nor will many of our friends and allies who perhaps are not being heard quite as vigorously as other friends and allies. The Group of Eight European nations stepped forward not too long ago and expressed their support for President Bush's approach.

Last Wednesday, after I spoke before the United Nations, the Vilnius 10, some of the newer free nations in Europe that have a clear understanding of what the future holds and why these dangers have to be dealt with, also stepped forward and expressed their support.

Much is being said this morning about disagreement in NATO as to whether or not our Turkish friends and our Turkish ally, our Turkish NATO colleague should be given support in this time of danger. Three of the European nations in NATO are saying, well, let's not do it at this time. But 16 nations are saying we should do it at this time.

So while we are hearing a lot about the three, let's remember 16 nations, including, of course, Turkey and the United States, that have stood up for Turkey. Turkey has now said under Article IV to the Alliance, we want to consult with the Alliance as to what our needs might be. I think this the is time for the Alliance to say to a fellow Alliance member we agree with you, and if you are concerned, we are concerned. That is what alliances are all about, and I hope NATO will be doing the right thing with respect to Turkey within the next 24 hours.

With respect to North Korea, we are following this situation very, very closely. It is not in the second-tier position, but it is not a 12-year problem, as we had with Iraq, with Iraq invading its neighbors, with Iraq using chemicals against its own people and its neighbors. This is a problem that emerged in recent months. We have been working it for just about three months now.

For a period of years, the international community had been led to believe that North Korea was acting in a way consistent with its obligations under a variety of agreements. A North-South agreement of the early 1990's between North and South Korea, where both sides agreed in writing that they would not pursue nuclear weapons. But North Korea was pursuing them. Then the Agreed Framework of 1994 when North Korea agreed to cap its activities with respect to reprocessing material into usable plutonium for nuclear weapons at the site known as Yongbyon. That was an agreement. Then between 1994 through the fall of 2000, other statements and agreements were entered into between the United States and North Korea. In the fall of 2000, President Clinton issued a statement that essentially said that the United States had no, hostile intention toward North Korea and assumed North Korea was following its obligations with respect to nuclear weapons.

The Nuclear Nonproliferation Treaty dealt with this. The IAEA was dealing with this. Then we came into office in early 2001. We took a long time to examine our policy with respect to North Korea because we were concerned about their proliferation activity. We were concerned about their sale of missile technology and what they were doing. Then after a long review, President Bush authorized me to begin engagement with North Korea. But it was about that same time that intelligence information became available to us. We could put it all together now and see that while everybody was looking at Yongbyon as having been sealed up, North Korea was pursuing nuclear weapons through another technology, enriched uranium. So everything they had been assuring us about turned out to be not good enough. They were working somewhere else.

So we could have ignored it. We could have looked another way, say let's not have a problem, let's not have a crisis, let's not call them on it. But we didn't. I met with the North Korean Foreign Minister. This business about we won't talk to them—I talked to him in Brunei at the end of July last year. I asked if he would like to have a cup of coffee. He agreed. We sat and we talked. I said, "look, we want to do things for your country, your people are hurting. But we need to deal with some issues having to do with proliferation and nuclear weapons and the size of the army that you have hanging over the 38th parallel. These are issues we will bring to the table, and we want to have a bold approach as to how we might be able to help you." He said, "fine, let's talk."

We then sent Assistant Secretary Kelly to North Korea a few weeks later. It took a while because there was a small problem in the region and we had to let that calm down. Assistant Secretary Kelly went in, but he had to say to them right up front that we know about this enriched uranium facility and program that you have got going. They were stunned that we knew it and that we had faced them with it. They thought about it overnight and came back the next day and said,"yes, we have it." " We do it, we are trying to develop the capability." They acknowledged it. We had to take that into account. They essentially said, "what are you going to do about it"?

What we said is this is not acceptable. It puts the whole Agreed Framework and all of the other agreements that you entered into at risk. It is not going to get you anywhere. We will not be cowed into giving you a new document or a new statement simply because you have admitted this. So let's find a way to discuss this, and let's find a way to move forward. But you must be held to account for these actions.

So over the last several months, we have been engaged with the international community. We have called upon the IAEA to meet its responsibilities, and they did. The Board of Governors called North Korea to account for its actions. North Korea responded by unsealing Yongbyon, and the Board of Governors of the IAEA will meet again in Vienna tomorrow to see what further action might be required.

We have said to the North Koreans we have no intention of invading or attacking North Korea. We have no interest in that. But we will defend our interests, and we have all of our options available to us. The option we are pushing is a diplomatic one, and we want to do it within a multilateral framework. Why not a multilateral framework? We are forever being accused of being unilateralist, and now when I want to be multilateralist, people are saying, no, be unilateralist. But it is a regional problem that affects more than the United States. It affects China, it affects Russia, it affects Japan, it affects South Korea. It affects other nations in the region. We believe those nations should be part of this solution.

We cannot, once again, have a solution that involves some direct engagement between the United States but does not include the rest of the region. The rest of the region can play a role in giving North Korea the kinds of security guarantees it is seeking, but at the same time making sure that this time we remove nuclear weapons as a threat in the Korean Peninsula and do everything we can to help the people of North Korea overcome the economic problems they have, the problems of starvation and deprivation that is affecting their people in such a negative way, and see if we can help them, help the society to deal with their problems and see if we can help them with the transformation that is going to be necessary for them to deal with their problems.

There is a tide of anti-Americanism, and there still is a threat from Al-Qaeda and Osama bin Laden. But our attention has not been diverted. Every morning the President starts out thinking about and talking to his senior advisers about Al-Qaeda, what they are doing, and the threats that we are facing. We can handle more than one issue at a time, and I think we are doing it rather well.

There is anti-Americanism out there. But there is also a groundswell of support for America. We are having difficulties right now with respect to some of our policies. There are concerns about our policies in the Middle East. The President intends to engage in the Middle East more aggressively than we have been able to in the past, now that the Israeli election is over and now that one way or the other we are going to deal with weapons of mass destruction with respect to Iraq.

I think that the current problems we are having with respect to anti-Americanism can be dealt with and can be reversed and changed as we move through to the conclusion of this issue with Iraq and as we engage more fully on the Middle East peace process. So I think there is still that groundswell of support for America, even though we are running through some difficult times right now with respect to some of our policies.

Mr. Chairman and members of the Committee, forgive me for taking so long with this opening statement, but Senator Conrad—I won't say asked for it but, invited it. [Laughter.]

[The prepared statement of Colin Powell follows:]

Secretary of State Colin L. Powell
Statement for the Record
Senate Budget Committee
February 11, 2003

Mr. Chairman, members of the committee, I am pleased to appear before you to testify in support of the President's International Affairs Budget for Fiscal Year 2004. Funding requested for FY 2004 for the Department of State, USAID, and other foreign affairs agencies is $28.5 billion.

The President's Budget will allow the United States to:

- Target security and economic assistance to sustain key countries supporting us in the war on terrorism and helping us to stem the proliferation of weapons of mass destruction;
- Launch the Millennium Challenge Account – a new partnership generating support to countries that rule justly, invest in their people, and encourage economic freedom;
- Strengthen the U.S. and global commitment to fighting HIV/AIDS and alleviating humanitarian hardships;
- Combat illegal drugs in the Andean Region of South America, as well as bolster democracy in one of that region's most important countries, Colombia; and
- Reinforce America's world-class diplomatic force, focusing on the people, places, and tools needed to promote our foreign policies around the world.

I am particularly proud of the last bullet, Mr. Chairman, because for the past two years I have concentrated on each of my jobs -- primary foreign policy advisor to the President and Chief Executive Officer of the State Department.

Under my CEO hat, we have been reinforcing our diplomatic force for two years and we will continue in FY 2004. We will hire 399 more professionals to help the President carry out the nation's foreign policy. This hiring will bring us to the 1,100-plus new foreign and civil service officers we set out to hire over the first three years to bring the Department's personnel back in line with its diplomatic workload. Moreover, completion of these hires will allow us the flexibility to train and educate all of our officers as they should be trained and educated. So I am proud of that accomplishment and want to thank you for helping me bring it about.

In addition, I promised to bring state-of-the-art communications capability to the Department – because people who can't communicate rapidly and effectively in today's globalizing world can't carry out our foreign policy. We are approaching our goal in that regard as well.

In both unclassified and classified communications capability, including desk-top access to the Internet for every man and woman at State, we are there by the end of 2003. The budget before you will sustain these gains and continue our information technology modernization effort.

Finally, with respect to my CEO role, I wanted to sweep the slate clean and completely revamp the way we construct our embassies and other overseas buildings, as well as improve the way we secure our men and women who occupy them. As you well know, that last task is a long-term, almost never-ending one, particularly in this time of heightened terrorist activities. But we are well on the way to implementing both the construction and the security tasks in a better way, in a less expensive way, and in a way that subsequent CEOs can continue and improve on.

Mr. Chairman, let me give you key details with respect to these three main CEO priorities, as well as tell you about other initiatives under my CEO hat:

The CEO Responsibilities: State Department and Related Agencies

The President's FY 2004 discretionary request for the Department of State and Related Agencies is \$8.497 billion. The requested funding will allow us to:

- Continue initiatives to recruit, hire, train, and deploy the right work force. The budget request includes \$97 million to complete the Diplomatic Readiness Initiative by hiring 399 additional foreign affairs professionals. Foreign policy is carried out through our people, and rebuilding America's diplomatic readiness in staffing will ensure that the Department can respond to crises and emerging foreign policy priorities. This is the third year of funding for this initiative, which will provide a total of 1,158 new staff for the Department of State.

- Continue to put information technology in the service of diplomacy. The budget request includes \$157 million to sustain the investments made over the last two years to provide classified connectivity to every post that requires it and to expand desktop access to the Internet for State Department employees. Combined with \$114 million in estimated Expedited Passport Fees, a total of \$271 million will be available for information technology investments, including beginning a major initiative – SMART – that will overhaul the outdated systems for cables, messaging, information sharing, and document archiving.

- Continue to upgrade and enhance our security worldwide. The budget request includes \$646.7 million for programs to enhance the security of our diplomatic facilities and personnel serving abroad and for hiring 85 additional security and support professionals to sustain the Department's Worldwide Security Upgrades program.

- Continue to upgrade the security of our overseas facilities. The budget request includes \$1.514 billion to fund major security-related construction projects and address the major physical security and rehabilitation needs of embassies and consulates around the world. The request includes \$761.4 million for construction of secure embassy compounds in seven countries and \$128.3 million for construction of a new embassy building in Germany.

- The budget also supports management improvements to the overseas buildings program and the Overseas Building Operations (OBO) long-range plan. The budget proposes a Capital Security Cost Sharing Program that allocates the capital costs of new overseas facilities to all U.S. Government agencies on the basis of the number of their authorized overseas positions. This program will serve two vital purposes: (1) to accelerate construction of new embassy compounds and (2) to encourage Federal agencies to evaluate their overseas positions more carefully. In doing so, it will further the President's Management Agenda initiative to rightsize the official American presence abroad. The modest surcharge to the cost of stationing an American employee overseas will not undermine vital overseas work, but it will encourage more efficient management of personnel and taxpayer funds

- Continue to enhance the Border Security Program. The budget request includes $736 million in Machine Readable Visa (MRV) fee revenues for continuous improvements in consular systems, processes, and programs in order to protect U.S. borders against the illegal entry of individuals who would do us harm.

- Meet our obligations to international organizations. Fulfilling U.S. commitments is vital to building coalitions and gaining support for U.S. interests and policies in the war against terrorism and the spread of weapons of mass destruction. The budget request includes $1 billion to fund U.S. assessments to 44 international organizations, including $71.4 million to support renewed U.S. membership in the United Nations Educational, Scientific, and Cultural Organization (UNESCO).

- Support obligations to international peacekeeping activities. The budget request includes $550.2 million to pay projected UN peacekeeping assessments. These peacekeeping activities ensure continued American leadership in shaping the international community's response to developments that threaten international peace and stability.

Continue to eliminate support for terrorists and thus deny them safe haven through our ongoing public diplomacy activities, our educational and cultural exchange programs, and international broadcasting. The budget request includes $296.9 million for public diplomacy, including information and cultural programs carried out by overseas missions and supported by public diplomacy personnel in our regional and functional bureaus. These resources are used to engage, inform, and influence foreign publics and broaden dialogue between American citizens and institutions and their counterparts abroad.

The budget request also includes $345.3 million for educational and cultural exchange programs that build mutual understanding and develop friendly relations between America and the peoples of the world. These activities establish the trust, confidence, and international cooperation with other countries that sustain and advance the full range of American national interests.

The budget request includes $100 million for education and cultural exchanges for States of the Former Soviet Union and Central and Eastern Europe, which were previously funded under the FREEDOM Support Act and Support for East European Democracy (SEED) accounts.

As a member of the Broadcasting Board of Governors, I want to take this opportunity to highlight to you the BBG's pending budget request for $563.5 million. Funding will advance international broadcasting efforts to support the war on terrorism, including initiation of the Middle East Television Network.

Mr. Chairman, I know that your committee staff will go over this statement with a fine-tooth comb and I know too that they prefer an account-by-account laydown. So here it is:

Diplomatic and Consular Programs (D&CP):

- The FY 2004 request for D&CP, the State Department's chief operating account, totals $4.164 billion.
- D&CP supports the diplomatic activities and programs that constitute the first line of offense against threats to the security and prosperity of the American people. Together with Machine Readable Visa and other fees, the account funds the operating expenses and infrastructure necessary for carrying out U.S. foreign policy in more than 260 locations around the world.
- The FY 2004 D&CP request provides $3.517 billion for ongoing operations – a net increase of $132.7 million over the FY 2003 level. Increased funding will enable the State Department to advance national interests effectively through improved diplomatic readiness, particularly in human resources.
- The request completes the Secretary's three-year Diplomatic Readiness Initiative to put the right people with the right skills in the right place at the right time. New D&CP funding in FY 2004 of $97 million will allow the addition of 399 professionals, providing a total of 1,158 new staff from FY 2002 through FY 2004.
- The FY 2004 D&CP request also provides $646.7 million for Worldwide Security Upgrades – an increase of $93.7 million over last year. This total includes $504.6 million to continue worldwide security programs for guard protection, physical security equipment and technical support, information and system security, and security personnel and training. It also includes $43.4 million to expand the perimeter security enhancement program for 232 posts and $98.7 million for improvements in domestic and overseas protection programs, including 85 additional agents and other security professionals.

Capital Investment Fund (CIF):

- The FY 2004 request provides $157 million for the CIF to assure that the investments made in FY 2002 and FY 2003 keep pace with increased demand from users for functionality and speed.
- Requested funding includes $15 million for the State Messaging and Archive Retrieval Toolset (SMART). The SMART initiative will replace outdated systems for cables and messages with a unified system that adds information sharing and document archiving.

Embassy Security, Construction, and Maintenance (ESCM):

- The FY 2004 request for ESCM is $1.514 billion. This total – an increase of $209.4 million over the FY 2003 level – reflects the Administration's continuing commitment to protect U.S. Government personnel serving abroad, improve the security posture of facilities overseas, and address serious deficiencies in the State Department's overseas infrastructure.

- For the ongoing ESCM budget, the Administration is requesting $524.7 million. This budget includes maintenance and repairs at overseas posts, facility rehabilitation projects, construction security, renovation of the Harry S Truman Building, all activities associated with leasing overseas properties, and management of the overseas buildings program.
- For Worldwide Security Construction, the Administration is requesting $761.4 million for the next tranche of security-driven construction projects to replace high-risk facilities. Funding will support the construction of secure embassies in seven countries – Algeria, Burma, Ghana, Indonesia, Panama, Serbia, and Togo. In addition, the requested funding will provide new on-compound buildings for USAID in Ghana, Jamaica, and Nigeria.
- The ESCM request includes $100 million to strengthen compound security at vulnerable posts.
- The request also includes $128.3 million to construct the new U.S. embassy building in Berlin.

Educational and Cultural Exchange Programs (ECE):

- The FY 2004 request of $345.3 million for ECE maintains funding for exchanges at the FY 2003 request level of $245 million and adds $100 million for projects for Eastern Europe and the States of the Former Soviet Union previously funded from Foreign Operations appropriations.
- Authorized by the Mutual Educational and Cultural Exchange Act of 1961(Fulbright-Hays Act), as amended, exchanges are strategic activities that build mutual understanding and develop friendly relations between the United States and other countries. They establish the trust, confidence, and international cooperation necessary to sustain and advance the full range of U.S. national interests.
- The request provides $141 million for Academic Programs. These include the J. William Fulbright Educational Exchange Program for exchange of students, scholars, and teachers and the Hubert H. Humphrey Fellowship Program for academic study and internships in the United States for mid-career professionals from developing countries.
- The request also provides $73 million for Professional and Cultural Exchanges. These include the International Visitor Program, which supports travel to the United States by current and emerging leaders to obtain firsthand knowledge of American politics and values, and the Citizen Exchange Program, which partners with U.S. non-profit organizations to support professional, cultural, and grassroots community exchanges.
- This request provides $100 million for exchanges funded in the past from the FREEDOM Support Act (FSA) and Support for East European Democracy (SEED) accounts.
- This request also provides $31 million for exchanges support. This funding is needed for built-in requirements to maintain current services.

Contributions to International Organizations (CIO):

- The FY 2004 request for CIO of $1.010 billion provides funding for U.S. assessed contributions, consistent with U.S. statutory restrictions, to 44 international organizations to further U.S. economic, political, social, and cultural interests.

- The request recognizes U.S. international obligations and reflects the President's commitment to maintain the financial stability of the United Nations and other international organizations that include the World Health Organization, the North Atlantic Treaty Organization, the International Atomic Energy Agency, and the Organization for Economic Cooperation and Development.
- The budget request provides $71.4 million to support renewed U.S. membership in the United Nations Educational, Scientific, and Cultural Organization (UNESCO). UNESCO contributes to peace and security in the world by promoting collaboration among nations through education, science, culture and communication and by furthering intercultural understanding and universal respect for justice, rule of law, human rights, and fundamental freedoms, notably a free press.
- Membership in international organizations benefits the United States by building coalitions and pursuing multilateral programs that advance U.S. interests. These include promoting economic growth through market economies; settling disputes peacefully; encouraging non-proliferation, nuclear safeguards, arms control, and disarmament; adopting international standards to facilitate international trade, telecommunications, transportation, environmental protection, and scientific exchange; and strengthening international cooperation in agriculture and health.

Contributions for International Peacekeeping Activities (CIPA):

- The administration is requesting $550.2 million for CIPA in FY 2004. This funding level will allow the United States to pay its share of assessed UN peacekeeping budgets, fulfilling U.S. commitments and avoiding increased UN arrears.
- The UN peacekeeping appropriation serves U.S. interests in Europe, Africa and the Middle East, where UN peacekeeping missions assist in ending conflicts, restoring peace and strengthening regional stability.
- UN peacekeeping missions leverage U.S. political, military and financial assets through the authority of the UN Security Council and the participation of other states that provide funds and peacekeepers for conflicts around the world.

Broadcasting Board of Governors (BBG):

- The FY 2004 budget request for the BBG totals $563.5 million.
- The overall request provides $525.2 million for U.S. Government non-military international broadcasting operations through the International Broadcasting Operations (IBO) account. This account funds operations of the Voice of America (VOA), Radio Free Europe/Radio Liberty (RFE/RL), Radio Free Asia (RFA), and all related program delivery and support activities.

- The IBO request includes funding to advance broadcasting efforts related to the war on terrorism. The request includes $30 million to initiate the Middle East Television Network – a new Arabic-language satellite TV network that, once operational, will have the potential to reach vast audiences in the Middle East. The request also includes funding to double VOA Indonesian radio programming, significantly increase television programming in Indonesia, and expand BBG audience development efforts.
- The IBO request reflects the shifting of priorities away from the predominantly Cold War focus on Central and Eastern Europe to broadcasting in the Middle East and Central Asia. Funds are being redirected to programs in these regions through the elimination of broadcasting to countries in the former Eastern Bloc that have demonstrated significant advances in democracy and press freedoms and are new or soon-to-be NATO and European Union Members.
- The IBO request also reflects anticipated efficiencies that achieve a five-percent reduction in funding for administration and management in FY 2004.
- The FY 2004 request also provides $26.9 million through Broadcasting to Cuba (OCB) for continuing Radio Marti and TV Marti operations, including salary and inflation increases, to support current schedules.
- The FY 2004 request further provides $11.4 million for Broadcasting Capital Improvements to maintain the BBG's worldwide transmission network. The request includes $2.9 million to maintain and improve security of U.S. broadcasting transmission facilities overseas.

That finishes the State and Related Agencies part of the President's Budget. Now let me turn to the Foreign Affairs part.

The Foreign Policy Advisor Responsibilities: Funding America's Diplomacy Around the World

The FY 2004 budget proposes several initiatives to advance U.S. national security interests and preserve American leadership. The FY 2004 Foreign Operations budget that funds programs for the Department State, USAID and other foreign affairs agencies is $18.8 billion.

Today, our number one priority is to fight and win the global war on terrorism. The budget furthers this goal by providing economic, military, and democracy assistance to key foreign partners and allies, including $4.7 billion to countries that have joined us in the war on terrorism.

The budget also promotes international peace and prosperity by launching the most innovative approach to U.S. foreign assistance in more than forty years. The new Millennium Challenge Account (MCA), an independent government corporation funded at $1.3 billion will redefine "aid". As President Bush told African leaders meeting in Mauritius recently, this aid will go to "nations that encourage economic freedom, root out corruption, and respect the rights of their people."

Moreover, this budget offers hope and a helping hand to countries facing health catastrophes, poverty and despair, and humanitarian disasters. It provides $1.345 billion to combat the global HIV/AIDS epidemic, more than $1 billion to meet the needs of refugees and internally displaced peoples, $200 million in emergency food assistance to support dire famine needs, and $100 million for an emerging crises fund to allow swift responses to complex foreign crises. Mr. Chairman, let me give you some details.

The U.S. is successfully prosecuting the global war on terrorism on a number of fronts. We are providing extensive assistance to states on the front lines of the anti-terror struggle. Working with our international partners bilaterally and through multilateral organizations, we have frozen more than $110 million in terrorist assets, launched new initiatives to secure global networks of commerce and communication, and significantly increased the cooperation of our law enforcement and intelligence communities. Afghanistan is no longer a haven for al-Qaeda. We are now working with the Afghan Authority, other governments, international organizations, and NGOs to rebuild Afghanistan. Around the world we are combating the unholy alliance of drug traffickers and terrorists who threaten the internal stability of countries. We are leading the international effort to prevent weapons of mass destruction from falling into the hands of those who would do harm to us and others. At the same time, we are rejuvenating and expanding our public diplomacy efforts worldwide.

Assistance to Frontline States

The FY 2004 International Affairs budget provides approximately $4.7 billion in assistance to the Frontline States, which have joined with us in the war on terrorism. This funding will provide crucial assistance to enable these countries to strengthen their economies, internal counter-terrorism capabilities and border controls.

Of this amount, the President's Budget provides $657 million for Afghanistan, $460 million for Jordan, $395 million for Pakistan, $255 million for Turkey, $136 million for Indonesia, and $87 million for the Philippines. In Afghanistan, the funding will be used to fulfill our commitment to rebuild Afghanistan's road network; establish security through a national military and national police force, including counter-terrorism and counter-narcotics components; establish broad-based and accountable governance through democratic institutions and an active civil society; ensure a peace dividend for the Afghan people through economic reconstruction; and provide humanitarian assistance to sustain returning refugees and displaced persons. United States assistance will continue to be coordinated with the Afghan government, the United Nations, and other international donors.

The State Department's Anti-Terrorism Assistance (ATA) program will continue to provide frontline states a full complement of training courses, such as a course on how to conduct a post-terrorist attack investigation or how to respond to a WMD event. The budget will also fund additional equipment grants to sustain the skills and capabilities acquired in the ATA courses. It will support as well in-country training programs in Afghanistan, Pakistan, and Indonesia.

Central Asia and Freedom Support Act Nations

In FY 2004, over $157 million in Freedom Support Act (FSA) funding will go to assistance programs in the Central Asian states. The FY 2004 budget continues to focus FSA funds to programs in Uzbekistan, Kyrgyzstan and Tajikistan, recognizing that Central Asia is of strategic importance to U.S. foreign policy objectives. The FY 2004 assistance level for Uzbekistan, Kyrgyzstan and Tajikistan is 30 percent above 2003. Assistance to these countries has almost doubled from pre-September 11th levels. These funds will support civil society development, small business promotion, conflict reduction, and economic reform in the region. These efforts are designed to promote economic development and strengthen the rule of law in order to reduce the appeal of extremist movements and stem the flow of illegal drugs that finance terrorist activities.

Funding levels and country distributions for the FSA nations reflect shifting priorities in the region. For example, after more than 10 years of high levels of assistance, it is time to begin the process of graduating countries in this region from economic assistance, as we have done with countries in Eastern Europe that have made sufficient progress in the transition to market-based democracies. U.S. economic assistance to Russia and Ukraine will begin phasing down in FY 2004, a decrease of 32 percent from 2003, moving these countries towards graduation.

Combating Illegal Drugs and Stemming Narco-terrorism

The President's request for $731 million for the Andean Counterdrug Initiative includes $463 million for Colombia. An additional $110 million in military assistance to Colombia will support Colombian President Uribe's unified campaign against terrorists and the drug trade that fuels their activities. The aim is to secure democracy, extend security, and restore economic prosperity to Colombia and prevent the narco-terrorists from spreading instability to the broader Andean region. Critical components of this effort include resumption of the Airbridge Denial program to stop internal and cross-border aerial trafficking in illicit drugs, stepped up eradication and alternative development efforts, and technical assistance to strengthen Colombia's police and judicial institutions.

Halting Access of Rogue States and Terrorists to Weapons of Mass Destruction

Decreasing the threats posed by terrorist groups, rogue states, and other non-state actors requires halting the spread of weapons of mass destruction (WMD) and related technology. To achieve this goal, we must strengthen partnerships with countries that share our views in dealing with the threat of terrorism and resolving regional conflicts.

The FY 2004 budget requests $35 million for the Nonproliferation and Disarmament Fund (NDF), more than double the FY 2003 request, increases funding for overseas Export Controls and Border Security (EXBS) to $40 million, and supports additional funding for Science Centers and Bio-Chem Redirection Programs.

Funding increases requested for the NDF and EXBS programs seek to prevent weapons of mass destruction from falling into the hands of terrorist groups or states by preventing their movement across borders and destroying or safeguarding known quantities of weapons or source material. The Science Centers and Bio-Chem Redirection programs support the same goals by engaging former Soviet weapons scientists and engineers in peaceful scientific activities, providing them an alternative to marketing their skills to states or groups of concern.

Millennium Challenge Account

The FY 2004 Budget request of $1.3 billion for the new Millennium Challenge Account (MCA) as a government corporation fulfills the President's March 2002 pledge to create a new bilateral assistance program, markedly different from existing models. This budget is a huge step towards the President's commitment of $5 billion in annual funding for the MCA by 2006, a 50% increase in core development assistance.

The MCA supplement U.S. commitments to humanitarian assistance and existing development aid programs funded and implemented by USAID. It will assist developing countries that make sound policy decisions and demonstrate solid performance on economic growth and reducing poverty.

- MCA funds will go only to selected developing countries that demonstrate a commitment to sound policies -- based on clear, concrete and objective criteria. To become eligible for MCA resources, countries must demonstrate their commitment to economic opportunity, investing in people, and good governance.

- Resources will be available through agreements with recipient countries that specify a limited number of clear measurable goals, activities, and benchmarks, and financial accountability standards.

The MCA will be administered by a new government corporation designed to support innovative strategies and to ensure accountability for measurable results. The corporation will be supervised by a Board of Directors composed of Cabinet level officials and chaired by the Secretary of State. Personnel will be drawn from a variety of government agencies and non-government institutions and serve limited-term appointments.

In FY 2004, countries eligible to borrow from the International Development Association (IDA), and which have per capita incomes below $1,435, (the historical IDA cutoff) will be considered. In 2005, all countries with incomes below $1,435 will be considered. In 2006, all countries with incomes up to $2,975 (the current World Bank cutoff for lower middle income countries) will be eligible.

The selection process will use 16 indicators to assess national performance – these indicators being relative to governing justly, investing in people, and encouraging economic freedom. These indicators were chosen because of the quality and objectivity of their data, country coverage, public availability, and correlation with growth and poverty reduction. The results of a review of the indicators will be used by the MCA Board of Directors to make a final recommendation to the President on a list of MCA countries.

Africa Education Initiative

With $200 million, the United States is doubling its five-year financial commitment to the African Education Initiative it launched last year. The initiative focuses on increasing access to quality education in Africa. Over its 5-year life the African Education Initiative will achieve: 160,000 new teachers trained; 4.5 million textbooks developed and distributed; an increase in the number of girls attending school through providing more than a quarter million scholarships and mentoring; and an increase African Education Ministries' capacity to address the impact of HIV/AIDS.

Increases in Funding for Multilateral Development Banks (MDBs)

The FY 2004 budget provides $1.55 billion for the MDBs, an increase of $110 million over the FY 2003 request of $1.44 billion. This includes $1.36 billion for scheduled payments to the MDBs and $195.9 million to clear existing arrears. The request provides $950 million for the International Development Association (IDA) for the second year of the IDA-13 replenishment, $100 million of which is contingent on the IDA meeting specific benchmarks in the establishment of a results measurement system. By spring 2003, the IDA is to have completed an outline of approach to results measurement, presented baseline data, and identified outcome indicators and expected progress targets. By that same time, the IDA is also to have completed specific numbers of reviews and assessments in the areas of financial accountability, procurement, public expenditure, investment climate, and poverty.

World Summit on Sustainable Development (WSSD)

The WSSD engaged more than 100 countries and representatives of business and NGOs. Sustainable development begins at home and is supported by effective domestic policies and international partnerships that include the private sector. Self-governing people prepared to participate in an open world marketplace are the foundation of sustainable development. These fundamental principals guide the U.S. approach to Summit initiatives. At the 2002 Summit the U.S. committed to developing and implementing realistic results-focused partnerships in the areas of: Water for the Poor; Clean Energy; Initiative to Cut Hunger in Africa; Preventing Famine in Southern Africa; and the Congo Basin Partnership. At the end of the Summit new relationships and partnerships were forged and a new global commitment to improve sanitation was reached. The FY 2004 Budget supports these partnerships with $337 million in assistance funding.

The U.S.-Middle East Partnership Initiative

The President's Budget includes $145 million for the Middle East Partnership Initiative (MEPI). This initiative gives us a framework and funding for working with the Arab world to expand educational and economic opportunities, empower women, and strengthen civil society and the rule of law. The peoples and governments of the Middle East face daunting human challenges. Their economies are stagnant and unable to provide jobs for millions of young people entering the workplace each year. Too many of their governments appear closed and unresponsive to the needs of their citizens. And their schools are not equipping students to succeed in today's globalizing world. With the programs of the MEPI, we will work with Arab governments, groups, and individuals to bridge the jobs gap with economic reform, business investment, and private sector development; close the freedom gap with projects to strengthen civil society, expand political participation, and lift the voices of women; and bridge the knowledge gap with better schools and more opportunities for higher education. The U.S.-Middle East Partnership Initiative is an investment in a more stable, peaceful, prosperous, and democratic Arab world.

Forgiving Debt – Helping Heavily Indebted Poor Countries

The Administration request provides an additional $75 million for the Trust Fund for Heavily Indebted Poor Countries (HIPC). These funds will go towards fulfilling the President's commitment at the G-8 Summit in Kananaskis, Canada to contribute America's share to filling the projected HIPC Trust Fund financing gap. The HIPC Trust Fund helps to finance debt forgiveness by the International Financial Institutions (IFIs) to heavily indebted poor countries that have committed to economic reforms and pledged to increase domestic funding of health and education programs. In addition, the President's request provides $300 million to fund bilateral debt reduction for the Democratic Republic of the Congo under the HIPC Initiative, as well as $20 million for debt reduction under the Tropical Forest Conservation Act (TFCA).

The Administration believes that offering new sovereign loans or loan guarantees to indebted poor countries while providing debt forgiveness to those same countries risks their return to unsustainable levels of indebtedness—a situation debt forgiveness seeks to resolve.

In order to address this situation, the Administration recently invoked a one-year moratorium on new lending to countries that receive multilateral debt reduction. U.S. lending agencies have agreed not to make new loans or loan guarantees to countries that receive debt reduction for one year. The measure will not be punitive. Should countries demonstrate serious economic gains before the end of the moratorium, lending agencies may, with interagency clearance, resume new lending. The Administration hopes that this policy will bring to an end the historically cyclical nature of indebtedness of poor countries.

American Leadership in Fighting AIDS and Alleviating Humanitarian Hardships

This budget reaffirms America's role as the leading donor nation supporting programs that combat the greatest challenges faced by many developing countries today. The FY 2004 budget proposes a number of foreign assistance initiatives managed by USAID and other federal agencies to provide crucial resources that prevent and ameliorate human suffering worldwide.

Fighting the Global AIDS Pandemic

The FY 2004 budget continues the Administration's commitment to combat HIV/AIDS and to help bring care and treatment to infected people overseas. The HIV/AIDS pandemic has killed 23 million of the 63 million people it has infected to date, and left 14 million orphans worldwide. President Bush has made fighting this pandemic a priority of U.S. foreign policy.

The President believes the global community can – and must – do more to halt the advance of the pandemic, and that the United States should lead by example. Thus, the President's FY 2004 budget request signals a further, massive increase in resources to combat the HIV/AIDs pandemic. As described in the State of the Union, the President is committing to provide a total of $15 billion over the next five years to turn the tide in the war on HIV/AIDs, beginning with $2 billion in the FY 2004 budget request and rising thereafter. These funds will be targeted on the hardest hit countries, especially Africa and the Caribbean with the objective of achieving dramatic on-the-ground results. This new dramatic commitment is reflected in the Administration's $2 billion FY 2004 budget request, which includes:

- State Department -- $450 million;
- USAID -- $895 million, including $100 million for the Global Fund and $150 million for the International Mother & Child HIV Prevention; and
- HHS/CDC/NIH -- $690 million, including $100 million for the Global Fund and $150 million for the International Mother & Child HIV Prevention.

In order to ensure accountability for results, the President has asked me to establish at State a new Special Coordinator for International HIV/AIDS Assistance. The Special Coordinator will work for me and be responsible for coordinating all international HIV/AIDS programs and efforts of the agencies that implement them.

Hunger, Famine, and Other Emergencies

Food Aid – Historically the United States has been the largest donor of assistance for victims of protracted and emergency food crises. In 2003, discretionary funding for food aid increased from $864 million to $1.19 billion. That level will be enhanced significantly in 2004 with two new initiatives: a Famine Fund and an emerging crises fund to address complex emergencies.

- **Famine Fund** – The FY 2004 budget includes a new $200 million fund with flexible authorities to provide emergency food, grants or support to meet dire needs on a case-by-case basis. This commitment reflects more than a 15 percent increase in U.S. food assistance.
- **Emerging Crises Fund** – The budget also requests $100 million for a new account that will allow the Administration to respond swiftly and effectively to prevent or resolve unforeseen complex foreign crises. This account will provide a mechanism for the President to support actions to advance American interests, including to prevent or respond to foreign territorial disputes, armed ethnic and civil conflicts that pose threats to regional and international peace and acts of ethnic cleansing, mass killing and genocide.

Summary

Mr. Chairman, members of the committee, to advance America's interests around the world we need the dollars in the President's Budget for FY 2004. We need the dollars under both of my hats – CEO and principal foreign policy advisor. The times we live in are troubled to be sure, but I believe there is every bit as much opportunity in the days ahead as there is danger. American leadership is essential to dealing with both the danger and the opportunity. With regard to the Department of State, the President's FY 2004 budget is crucial to the exercise of that leadership.

Thank you and I will be pleased to answer your questions.

Chairman NICKLES. Mr. Secretary, thank you very much for your comments. We are delighted that you are here today. I think you have done a lot to dispel this anti-Americanism sentiment that seems to be somewhat more prevalent in Europe, and maybe it is exaggerated in some areas.

I also want to compliment you and the Bush administration. You have inherited some big problems. You are Secretary of State, but in August 1998, two of our embassies were attacked and a couple of hundred people were killed, over a couple of hundred people were killed in Tanzania and Kenya. That was in August 1998. So it is part of your responsibility, part of our responsibility to make sure we protect those embassies.

You have asked for a significant amount of funds, I believe $4.7 billion, to combat terrorism, and I think included in that is also protection of our embassies and our American personnel. But you inherited that problem. Those embassies were attacked by Al-Qaeda. When you and the President mentioned that you are going into Afghanistan, many people predicted a quagmire. You have been very successful. I compliment you. I think very few people have looked back and maybe patted you enough on the back. The success that we had with the—I am going to say the minimal loss of life in Afghanistan is really historic. The liberation of Afghanistan, that is a monumental achievement. You are certainly to be complimented on it. You were breaking up Al-Qaeda. Now, maybe they have moved and they have hidden, and the hunt continues. But that is a problem that you inherited. Those embassies were attacked in 1998. The USS Cole was attacked in 2000. Not much was done or at least not much visible or aggressive enough, at least in this Senator's opinion. Why didn't we do more to get Al-Qaeda earlier? But you have gone after that problem.

You inherited a problem in Iraq. With respect to the noncompliance, there was, I think, 16 U.N. resolutions. President Clinton spoke very forcefully in February 1998, when he said, talking about Saddam Hussein, that if Hussein fails to comply and we fail to act or we take some ambiguous third route, which it sounds like the French are pursuing now, this gives him yet more opportunities to develop this program of weapons of mass destruction. It allows him to continue to press for release of sanctions, continue to ignore the solemn commitments he has made, and he will conclude that the international community has lost its will. He will then conclude he can go right on and do more to rebuild an arsenal of devastating destruction and someday, some way, I guarantee you, he will use the arsenal.

I think every one of you who has really worked on this for any length of time believes that is true. That was Bill Clinton in February 1998. But we didn't do much. Certainly the collective community didn't do much, and the arms control inspectors were kicked out in 1998, and Hussein continued to build his arsenal.

So now this administration, and you particularly, has really led and said we need to enforce these resolutions, so that the United Nations will have some credibility. You were successful in passing—not easily, I might mention—the last U.N. resolution. Then you presented the case very forcefully, very clearly, and very diplomatically last week before the United Nations.

So I just mention those events. You have inherited some big problems. You have gone after it and had exceptional success in Afghanistan. We still have work to do. Now you are going after, I believe, trying to clean up this problem, that Bill Clinton and others have identified, as really there, Iraq building weapons of mass destruction and which you put together so well in your speech last week. It is really not acceptable to think that Iraq can be building these tons of weapons such as anthrax and giving those or possibly distributing those to terrorists.

There are some of reports suggesting the dissolution of NATO with three countries, particularly led by the French in undermining NATO. Correct me if I am wrong, but France is not a military partner in NATO. Is that correct?

Secretary POWELL. It is part of the Alliance but not part of the military component of the Alliance, the integrated military component.

Chairman NICKLES. I am amazed at their presumption that they are controlling the alliance, but they are not a part of the military alliance. I don't believe NATO has bases in—or the U.S. doesn't have them. Does NATO have bases in France?

Secretary POWELL. As you recall, France evicted NATO headquarters back in 1966, or thereabouts.

Chairman NICKLES. I was just pointing that out. I am kind of interested in that. Also, the alliance and NATO's interests, the Persian Gulf War in 1991 was not a NATO operation. That was a coalition that you and President Bush and his team and Secretary Baker at the time put together. Is that correct?

Secretary POWELL. Yes, sir. It was a Coalition of the Willing under a U.N. Security Council resolution. Many NATO nations joined us there, but it was not a NATO operation.

Chairman NICKLES. Well, budget-wise, you mentioned $4.7 billion you have requested for the war on terrorism. Are you receiving the funds that you need? Many in Congress may say we want to give you more whether you want it or not. Are you getting adequate funds for rebuilding, sustaining our efforts in Afghanistan and Pakistan and other countries of concern and interest and cooperation in the war against terrorism?

Secretary POWELL. Sir, we are getting good support, and I just might mention that the embassy construction account, is $1.5 billion on top of the $4.7 billion that you mentioned a moment ago.

Obviously I cannot tell you that it is all the money I could use. But I think within the constraints that exist in the Federal budget, and after the President has examined all of his priorities, I think that the allocation that the State Department is getting in the overall Federal budget is adequate. And we are pleased that we have a real increase in our budget, including the Millennium Challenge Account, which showed a very significant increase, but even without the Millennium Challenge Account, we are getting an increase in our budget. We have fared well in the budget deliberations.

Chairman NICKLES. Secretary Powell, thank you very much.

One additional comment. You mentioned in North Korea that when this became more public that they were working on the enriched uranium facility, can you tell us when we believe that work started?

Secretary POWELL. I can't be precise, but it started certainly by 1998 or 1999. As we looked into it, when it became clear to us in 2002, and we could start now to look backward in time to see what had been missed earlier. Clearly it was begun in 1998, 1999 at the latest. When political decisions were made at the start of it at that time, I haven't been able to determine. But it was during the years of the previous administration. But they had no way of knowing it. President Clinton and Secretary Albright had no way of knowing that. Frankly, we didn't know it for the first year-plus of our administration.

So I am not being critical of the previous administration. They didn't know it, nor did we until last summer when the pieces started to come together. The Intelligence Community made us aware of it over the summer. We kept pressing back saying you have got to make sure of this before we go anywhere with it and start telling our friends about it and face the North Koreans with it. We have got to make sure. The more we looked, the more they went back in time, the pieces started to come together.

Chairman NICKLES. Well, correct me if I am wrong, but when they were building the plutonium plant—in Yongbyon?

Secretary POWELL. Construction of the 5 mega watt reactor at Yongbyon, began in the early 1980's and was completed in 1986.

Chairman NICKLES. When they were building that, that was in violation of the Nuclear Nonproliferation Treaty, which they had previously signed.

Secretary POWELL. Yes.

Chairman NICKLES. Then they were paid in terms of oil and nuclear power plants not to produce at that plant, and they shut that plant down. Shortly after, then, they started a new plant which was in violation of their framework agreement.

Secretary POWELL. Yes, sir. The Agreed Framework froze the activity at Yongbyon, shut down the 5-megawatt reactor, and the reprocessing facility. Unfortunately, it didn't take it out. It didn't remove it. The Agreement that was arrived at at that time was that work would stop, the reactor wouldn't work, the reprocessing facility and another facility there would not be operated. Light water reactors would be provided to the North Koreans to satisfy their power needs, and until the light water reactors came on to assist them with their power needs, we would provide heavy fuel oil for their generating capacity. That was the Agreed Framework deal.

It did serve the purpose for 8 years of not allowing plutonium to be developed at Yongbyon for the use of weapons, so that was good. But at the same time, somewhere in that period, early in that period, North Korea made a political decision that, fine, while everybody is looking at Yongbyon, let's start using enriched uranium as another technique to develop a nuclear capability.

Chairman NICKLES. Wasn't that agreement to prevent types of technology or different nuclear facilities?

Secretary POWELL. The Agreed Framework specifically dealt with Yongbyon, but it was in the spirit of no nuclear weapons development. There were other agreements: the Nonproliferation Treaty, the Safeguards Agreement, and the North-South Agreement between South Korea and North Korea. So there is no question that the entire international community as a result of the Agreed Framework, NPT, Safeguard Agreement, and the North-South Agreement all were going through the 1990's with the clear understanding and expectation that North Korea had made a commitment through these agreements not to further develop a nuclear weapon. But they weren't doing it.

Chairman NICKLES. Thank you very much.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Secretary, for your excellent presentation this morning. Two follow-up questions, if I could.

First, with respect to containment, you indicate that containment is not a strategy that makes sense with respect to Iraq because it failed to disarm Saddam. My understanding of the strategy of containment was it was not a disarmament strategy. Certainly the Soviet Union had weapons of mass destruction in great number—chemical, biological, nuclear. We never sought to use containment to get them to disarm. We sought to use containment to prevent them from using it. Basically what we had was mutually assured destruction.

In the case of Iraq, what we would have is an understanding that if we ever had any sense that he was going to use them or did use them, we would simply obliterate the country.

Why is that not an effective strategy?

Secretary POWELL. I think an argument can be made that that might have been effective prior to 9/11. But when you see the emergence of groups such as Al-Qaeda, when you see Al-Qaeda presence in Iraq, when you see contacts taking place between Al-Qaeda and Iraqi leaders, and when you see that Iraq has been a state sponsor of terrorism and has demonstrated its willingness to participate in terrorist activities over the years, and when you see the nature of that regime, I think it is no longer a prudent course of action to rely solely on containment.

With the Soviet Union, we had a more rational actor. We had a series of agreements that we could verify, and I participated in negotiating a number of those agreements, whether it was the INF Treaty or START-I or the Conventional Forces in Europe Treaty—a variety of agreements in international law between two very, very powerful nations that understood the nature of their power. Frankly, during my days as Chairman and my days as National Security Adviser, I wasn't worried about the Soviet Union leadership in the Kremlin 1 day deciding that, gee, it might be clever and useful of us to let some of this stuff slip out and be used by a terrorist organization.

They understood the seriousness of having such weaponry, and they protected it and took care of it. In fact, it was after the Soviet Union broke up that we started to worry that some of that material might leak out. Along came the Nunn-Lugar Program and a number of other comprehensive threat reduction programs to get rid of this material before it could leak into the hands of terrorist organizations. With the rise of terrorist fundamentalist organizations such as Al-Qaeda over the last 10 to 12 years, I think it fundamentally changes the situation.

Senator CONRAD. Could I ask just one follow-up, which would be: Why doesn't that same analysis apply to North Korea? Not only are they bad actors and unpredictable, I think everyone would say, but more than Iraq, they appear to be much further along in terms of developing nuclear weapons, perhaps already have some. They are desperately poor, and could make money by selling weapons. Why doesn't that same analysis that applies to Iraq apply to North Korea?

Secretary POWELL. It does. We are very concerned about proliferation. We know that North Korea has shared its knowledge. We know that it sells weaponry. The previous administration tried to deal with this problem through the Agreed Framework which capped Yongbyon. When this administration came into office, the previous administration was working with the North Koreans to try to bring under control their proliferation activities and to find a way to get them out of that business.

But, the problem was not solved when we came into office. We came into office, reviewed the situation, and began to engage the North Koreans on why there was a better way to move forward to a better future for their people than selling weapons and proliferating knowledge and activities. That still remains our policy. It doesn't mean that the only way to go about this problem is to immediately reach for a military solution.

I think that there are still diplomatic ways, working with our friends and neighbors in the region, powerful friends and neighbors in the region who have influence over North Korea, to convince them that it is time to get out of this business. North Korea, with no natural resources that people are terribly interested in, with an economy that is not functioning, with a population that is in enormous distress, still clings to the possibility that missile technology and weaponry of this type gives them political currency that they would not otherwise have. What we have to do as part of our diplomatic strategy is to persuade them, slowly—and it will take time; they are not a regime that responds instantaneously—but slowly over time persuade them and convince them that the possession of this kind of capability will not cause us to give them something or to provide them with something that does not ultimately deal with the problem.

They want a security guarantee. Will they give up all of their weapons, finally, totally in response to being provided a security guarantee from the United States or from regional powers? That is what we will have to see.

What would not be acceptable, it seems to me, Senator, is for us to say we will provide some kind of document that guarantees your security in return for your thinking about giving up your nuclear weapons or giving up—resealing Yongbyon but continuing to do something else. We need a total, comprehensive solution, and it will take time to get there because the North Koreans obviously are wary of, you know, the integrity of their regime and what threats their regime may be under. We have said we have no plans to invade. We are desperately concerned about the starving people of North Korea. We want to help them. The solution lies in diplomatic efforts that engage them, multilaterally, and ultimately us talking to them within that multilateral setting that can start to roll this back. But at the same time, we must make them absolutely aware of the fact, and the reality, that we have not taken any of our options off the table. We remain strong and our options are all on the table, but we are looking for a peaceful, diplomatic solution.

Chairman NICKLES. Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for an excellent presentation. You touched on a lot of issues which are very important and which I think you have fully explained. One issue, however, that you didn't touch on which I would be interested in is the question of Turkey and the recent veto of Turkey's request for defense from the NATO allies, which it is a member of—I think it is a military member of NATO—and whether or not the United States will unilaterally—and in my opinion, it should—stand by Turkey so that Turkey feels some comfort from our support.

Secretary POWELL. We will stand by Turkey, and not just the United States alone. Sixteen of the 19 NATO nations said that they wanted to respond to Turkey's request. NATO works by consensus.

Senator GREGG. Unanimous rule.

Secretary POWELL. Sir?

Senator GREGG. Doesn't NATO work by unanimous——

Secretary POWELL. It works by unanimity. That is what these Alliances are about. And it is soon going to get to 26, and it may be even more difficult to get a consensus at some point in the future. But we still are hopeful that a way can be found for the Alliance to respond, and we are undertaking the most intense diplomacy today, talking to France, Germany, and to Belgium to see if they would not change their position because all we are essentially doing is responding to a member nation's request for planning assistance in the event of some trouble that may lie ahead. I think that is a perfectly reasonable request, and France and Germany and Belgium at the moment are using their blocking power for really a different purpose, and that is to signal their disagreement with the approach that we need to bring this to a resolution with Iraq in the very near future in the U.N.

So we hope that intense diplomacy will persuade those three countries that this is the time to stand by a fellow NATO member who has asked for help. If we do not succeed in breaking that deadlock in NATO, I think that would be unfortunate, but, nevertheless, we will go ahead with those nations who are so inclined. There are nations willing now to provide that support to Turkey to make sure that Turkey gets the support that it needs.

Senator GREGG. I would just note as a side comment that we have had experience with unanimity as a form of government in Poland—I think it was in the 1600's, maybe the 1700's—and it totally failed. Doesn't that undermine the capacity of NATO to function? Isn't this a classic example of the risks that NATO puts itself in with the rule of unanimity and now the expansion of member States?

Secretary POWELL. Well, for over 50 years it has operated under these rules, and it is perhaps the most successful political and security alliance in history. But it does mean that you have to work with each member nation and persuade and convince and cajole and debate, and sometimes you succeed. Most times you do succeed; you do end up with full agreement on most of the things that the alliance has done for peace and security in Europe and the world. Sometimes you aren't able to achieve it, and then you find another way to solve the problem.

Senator GREGG. On another subject, the Administration has proposed—and I congratulate it for its moving in this direction—a significant expansion of our efforts to fight AIDS internationally. But my concern is that you are running it through the Global AIDS Fund. There is a GAO report which will be coming out fairly soon on this fund. It does mean that these dollars—$15 billion is the projected amount—will be running through a third-party organization, which, although we now have the Chairmanship of, we do not have the voting control over. Europeans basically control this fund. I am wondering if the GAO report finds, as I suspect it might, that this fund is filled with patronage, mismanagement, and inefficiency and waste, which is unfortunately a common event in these international groups, whether the Administration would be willing to consider a different approach to how we get this money into these needy countries and to the people who need it.

Secretary POWELL. I have not seen the GAO report. We would be deeply concerned if there were suggestions that patronage, mismanagement, and all the other things you mentioned were contaminating the work of the fund. It is a new organization, just up and running. My knowledge of it suggests that it is off to a pretty good start. I am sure there are some startup problems, however. We are very pleased that Secretary Thompson will now be the Chair of the Board. I am sure he will bring dynamic leadership to it, even though, it is a multilateral organization and others will have their say on where the funds should be distributed. But it has selected a number of projects already that seem to be worthy programs going in the right direction. But obviously, Senator, when the report comes out, I will read it with intense interest. We have no intention of ignoring problems if they exist of the kind you mention.

Senator GREGG. Well, philosophically, why would we use this fund versus going on a more unilateral basis and making sure that these tax dollars did end up where they are supposed to go?

Secretary POWELL. Well, we do have a number of other ways of distributing funds. As you know, the President's new Emergency Plain for HIV/AIDS will not flow money through the Global AIDS Fund, the fund you are talking about, except for $1 billion of the $15 billion. We also have a number of bilateral arrangements with countries on supporting them in their HIV/AIDS programs. But the Global AIDS Fund was a way of generating resources from many nations throughout the world, as well as private organizations and individuals. I think it is just up and running, and I think it is off to a pretty good start. It was a U.S. initiative working with the United Nations, and I think we ought to at least give it the benefit of the doubt as it goes through this second year of existence with the $2 billion that it has been able to raise.

Senator GREGG. I have some other questions, but I will wait.

Chairman NICKLES. Senator Gregg, thank you very much.

Senator Hollings.

Senator HOLLINGS. Mr. Secretary, like the others, I want to thank you for the excellent presentation and the calming influence you have had in the past 2 years. With all of this big talk, braggadocio, you are either with us or against us, I am sick and tired, it is all over with, it is a bad movie and I am not going to listen to it, that sort of frightens the international community, much less some here in this country. When you are running around deploying a couple of hundred thousand troops and all the weaponry you have got, it is need, the calming influence.

Let me tell you from whence I come. I don't have any idea of any immediate threat from Iraq of weapons of mass destruction. If there were an immediate threat of weapons of mass destruction, we have got the Israelis, the best assault team in the world. They have already proved their mettle. They know what is going on. Their Mossad intelligence is the best. They have already knocked out a nuclear plant, and if there was a weapon of mass destruction that was of an immediate threat, there is no question that the Israelis—they wouldn't dilly around and look for more inspectors or make telephone calls or anything else. They would hit it. They would knock it out. So I am not worried about that.

That being the case, will war lessen the use of weapons of mass destruction? Will that cause more likely the use of weapons of mass destruction or the less likely use of it?

Secretary POWELL. First and foremost, it will remove one of the sources of such weaponry, because if it comes to war because Iraq would not disarm peacefully, Iraq will be disarmed. In this place that has devoted so much money, time, energy, and political leadership to developing these kinds of weapons, that will all stop. The place will be sanitized. It will be cleaned out. There will be no weapons of mass destruction for any future Iraqi leadership to use or for any terrorist to get their hands on. I can assure you, Senator, that the Israelis, who, you are quite right, are very knowledgeable about these sorts of matters, have shown no reservations about the need for someone to disarm Iraq, either peacefully or otherwise.

It is not so much whether there is an imminent threat I can see. Unfortunately, imminent or immediate threats, those are not the troublesome ones. It is the one that you didn't think was immediate or imminent, but suddenly, bang, it has happened, it is there. We didn't think there was an immediate threat of somebody flying airplanes into our buildings, the World Trade Center or the Pentagon.

Senator HOLLINGS. But the flying of the planes into the buildings was caused by Osama bin Laden, who didn't like us having an air field in Saudi Arabia.

Secretary POWELL. Yes, well, I would not like to think that.

Senator HOLLINGS. That was the presence there. Now, what we are demanding here by invading Iraq is the presence in an Islam country, and the question arises: Are we really getting rid of Al-Qaeda or are we creating more Al-Qaeda with an invasion?

Secretary POWELL. First of all, I would not like to see Al-Qaeda going into the subways of New York or some other crowded facility in our Nation or in a nation of Europe and releasing anthrax or botulinum toxin or using ricin as a way of killing people, and the source of that material was Iraq or some other nation. So I think getting rid of the source of such material, potential source of such material would be in our interest.

I think that if it becomes necessary to use military force in Iraq, it will be done in a way that will be seen as surgical, it will be seen as a military operation that is not targeting the people of Iraq or the institutions or the infrastructure of Iraq. After it is over, I think you will see, as so many people and nations have seen in the course of the last 100 years, that the United States comes not to occupy, it comes not to impose its will, it comes not to gain sovereignty over a place but to make a place better than when we went in.

I think you will see humanitarian aid immediately start flowing to the people of Iraq. I think you will see us trying to build on the institutions that are existing in Iraq. We don't want to have to run all of Iraq. We want to build on the institutions. What we want to do is cut out the abscess, get rid of the infection and see if we can put in place a political system that will represent the people of Iraq, that will create a country that wants to live in peace with its neighbors, no longer has weapons of mass destruction, and is using its $20 billion a year of oil revenue to build schools, to build infrastructure, to put in place a health care system, and to make a better Iraq which could be a model for the rest of the region.

Senator HOLLINGS. Well, we both hope that is the case, Mr. Secretary, because there is a majority in that region that would think that we were the infidel in the land, in the Holy Land of Islam. So I have got my fingers crossed about the cost, whether it will work, and everything else. But as Secretary of State, I know you put a lot of trust, a lot of value in alliances. Now, you have got to make a command decision. Do you cause the break-up of the alliances in NATO and the United Nations by barreling in? Specifically Belgium is a wonderful friend, France, Lafayette, we are here, I fought with the French in World War II. Don't call them cowards. I can tell you that right now. I would be glad to come before this committee and testify. Germany we have got now, that is a good friend; Russia, China. Don't give me the political poll of 15 versus 4 or whatever it is. I was tempted, listening to Chairman Nickles when he wants to deride the Clinton administration, the majority of the people of America voted for it. So let's don't start that game.

I think we have got to be a little bit more deliberate. You are the Secretary of State. You have been the calming influence, and you really believe that, regardless of China, Russia, and everyone else in the alliances, that we just go ahead and break up the alliance just to get Saddam, who is not an immediate threat.

Secretary POWELL. France, Russia, China, all voted for 1441. We took our time. We were deliberate. We consulted. We talked. We aren't breaking up the Alliance. We are just making sure the Alliance, both the U.N. Alliance and the NATO Alliance, deals with this responsibility and remains relevant to the task put before it. If the United Nations passes 16, 17, 18 resolutions saying to a country like Iraq and a dictator like Saddam Hussein, "You must disarm", and he says, "No, I am not"; and the Alliance doesn't do anything about it, doesn't respond, particularly when a resolution was passed by all of them saying what would happen if he did that, then who is breaking up the Alliance? Not the United States. The

Alliance is breaking itself up because it will not meet its responsibilities.

Now, with respect to the infidel charge, the people of Kuwait didn't think we were infidels when we went in there and kicked out the Iraqi army in 1991. They welcomed us.

The people of Kosovo didn't think we were infidels when we went in there to help the people, the Muslims of Kosovo. I can assure you that the people of Afghanistan do not think we are infidels, because we went out there and took out a terrible regime and the people of Afghanistan can see that all we are trying to do is help them put in place a new government responsible to the people and that the international community has come to help them. They know we are going to leave as fast as we can.

Senator HOLLINGS. Well, this is the Budget Committee. Do you think we ought to pay for the war?

Secretary POWELL. I think we have to do what we think is right.

Senator HOLLINGS. No, I mean pay for the war. Of course, I think it is right. We have always paid for all the other wars. But you have got another gentleman from the Federal Reserve testifying, as you are testifying, that what we really need is a tax cut and that we ought to send those boys into Iraq and hope they get back. The reason we hope they get back alive is they are going to have to pick up our bill, because this Congress is not going to pay for it.

Secretary POWELL. Mr. Chairman, I can't speak on that issue. The issue I can speak on is that we have to meet our worldwide responsibilities, and if conflict is necessary—and we hope it is not, the President is still hopeful for a peaceful solution—then we have to do what we have to do. Whatever it costs, the cost has to be borne, hopefully not just by the United States but by other nations who will be in this coalition with us.

We are not going into this alone, and there has been a steady stream of visitors to the Oval Office to make the case to the President that he is not going in alone. You heard Prime Minister Howard yesterday, the Prime Minister of Australia. You heard Prime Minister Berlusconi, Prime Minister Blair. We are not going in this alone.

Senator HOLLINGS. Thank you, Mr. Chairman.

Chairman NICKLES. Thank you.

Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman.

Secretary Powell, thank you for your leadership. This Congress is behind you. We voted in the Senate 77-23 to authorize you and the President and the whole team to evaluate this circumstance in Iraq, to guarantee that this dictator would disarm, and we authorized you to use force if necessary—without a vote of the United Nations, without a vote of NATO, and alone if need be. I thank you for the work you have done to assemble a majority of the nations in the European area overwhelmingly to be supportive of that, and I think we are making great progress. It is just good to see. Some of the nations, I am sure, in Europe are under a good bit of pressure from France and Germany perhaps to not stand with us, but they stood with us. They have written editorials and letters affirming our policy. They voted with us on the Turkey question.

So I think a lot of progress has been made, and I salute you for that, and I believe that in the long run, if the United States does not stand firm now to allow the resolutions of the United Nations and our own firm commitments to be eroded and not be acted upon, then we have not done well. In the long run, peace and stability in the world will not be there. I know other people in the world may be nervous about this, but if it turns out—certainly it won't be perhaps as quick as the Afghan operation. But if it turns out it is good for the people of Iraq, even partly as good for those people as it did for Afghanistan, then I think the people of the world will appreciate what we have done.

We are not there to take oil. We are there to protect our security interests and liberate the people of Iraq. I just salute you for it. It is a difficult time, and I wanted to make that comment.

I really would be surprised if Senator Hollings would suggest that we would expect some other nation to defend our security interests. I don't think that is reasonable. I don't think we should do that. It would be a stunning development were we to do that.

You know, we had in our committee—Senator Gregg chaired the Health, Education, Labor, and Pensions Committee, and we had Sir Elton John talk about AIDS. His call was very passionate for us to do more. I believe we should do more. I support the President, the great increase in efforts for this colossal worldwide tragedy. But I asked Sir Elton John, What can we do to make sure the money is well spent? I referred to his foundation that he meticulously monitors to help with the AIDS circumstances in Africa. I noted that many experts say if you give the money to the governments in Third World countries, it oftentimes does not get to the people who really are in need. We have got this new group, this Global AIDS Initiative, that perhaps can be effective in that regard.

But can you give us some assurance—and let me just mention to you what Sir Elton John said when I asked him about this problem. He replied, "I concur with you totally. What that money has to go toward is training people to build an infrastructure so people can get drugs they need in remote parts of countries, and it needs to be run on a government level. But I know what you are saying. I do not know how you do that, because I am just a singer. This is something that the politicians have to make sure that when the money goes to governments, the money is spent in the right way. I have said before that we are a small AIDS organization. We can control where everything goes, and we do. We know where every penny goes. But when you get these vast sums of money that we are talking about here today, you are going to run into those kinds of problems, and I do not personally know myself how you solve them. But I concur that it is a major problem."

I know you have thought about that. What can you tell us about your plans?

Secretary POWELL. With respect to the President's new Emergency Plan, it will be run by a Special Coordinator with the rank of Ambassador representing the President and me, located in the State Department. We are now looking at the right organizational arrangements.

The money will be used in a way that will support sometimes government efforts, sometimes directly to private efforts.

There is a certain surface attraction to the idea to forgetting all about governments and go right to private NGO's. But, in reality, when you get into many of these countries, you really have to use and buildup and assist their government health care system to deliver these services.

What we have to do is make sure that we build the infrastructure in a sensible way for them to deliver the services. Sometimes it will go directly to a private NGO over the government but with the knowledge of the government because you don't want conflicting policies. We have to make sure that we put in place solid systems for accountability and solid systems for transparency and solid systems for making sure that it goes through the government agencies and out to the people in need; and that we are actually delivering services, not getting ripped off, and not seeing the money go into bureaucratic ratholes. That is a challenge for us and a challenge we have to meet.

To some extent, it also bounces against the Millennium Challenge Account where we are going to be investing and looking at those countries that are committed to democracy, committed to transparency, committed to the rule of law, committed to ending corruption. That same sort of test should be applied with respect to the global initiative to make sure it is going to countries that truly are committed to this and will use the money for the intended purpose and make sure it gets out to the delivery system and not just to the bureaucratic system.

Senator SESSIONS. Well, you know, you lose a few million dollars here and a few million dollars there, and tens of thousands of victims of AIDS will not be getting the medicines. So we want to make sure that every single dollar gets there.

Will this new Ambassador, for the lack of a better word around here, be a czar-like person that would have the ability to convene all the agencies involved and speak to the Congress as to the effectiveness of the program?

Secretary POWELL. Yes, we intend for this person to not just be another bureaucrat who can't go to the washroom without my permission, but somebody who is carrying not only my authority but the authority of the President to bring together whoever needs to be brought together to deal with the issue of cross-agency boundaries.

It would have to be somebody who has the ability to work, however, closely and in close coordination with AID and with the Global AIDS Fund and all the other other organizations such as HHS that are involved in the AIDS fight. But for this program of $15 billion over 5 years, it will be somebody with unique authority and responsibilities and able to do just what you just described and also be available to speak to the Congress, testify before the Congress, and justify the program before the Congress.

Senator SESSIONS. If this Global AIDS Initiative that we are going to work closely with and you plan to contribute to—it makes me somewhat nervous because we do lose some management control there. If that organization fails to function effectively, are we able to get out of it? Are we signing some sort of long-term contract that we would have to continue?

Secretary POWELL. Well, the first year request is for $450 million, and you have the power of the purse every year, and it is a totally owned U.S. Government organization subject to the will of the Congress. So you have full control over it.

I would hope that control would not be exercised with too many earmarks and legislative direction.

Senator SESSIONS. I just think we will need to, Mr. Chairman, make sure that those agencies are actually utilizing the money that they receive as effectively as absolutely possible, and if they are not, we shouldn't hesitate to use another route.

Thank you, Secretary Powell, for your leadership.

Secretary POWELL. Thank you, Senator.

Chairman NICKLES. Senator Sessions, thank you very much for your statement.

Senator Stabenow.

Senator STABENOW. Well, thank you, Mr. Chairman. Thank you very much for your service to our country.

First just a comment following up on Senator Hollings in terms of the budget, and just a comment that as we are facing possible war with Iraq, as we have the war on terrorism, we are seeing on this Budget Committee numbers that show us going further and further in debt as a country. I have deep concerns about what that means. We should be paying for these efforts and not putting it on the American credit card. I hope that as we discuss the budget we will be discussing that as well.

Mr. Secretary, as we are talking about the issues of terrorism—and you mentioned earlier Al-Qaeda, heaven forbid that they are back here in our country and another outrageous attack killing Americans happens, I would like to speak for a moment about the issue of homeland security or hometown security, as I think it is appropriately called. While this is not within your realm in terms of the budget, I know that you play an important role as we are determining priorities. I would just share with you I have now had nine different meetings around Michigan, small towns in the Upper Peninsula to Detroit, to the west side of the State, one yesterday in Port Huron, Michigan, along the river between Canada and the United States as we go into Lake Huron. I hear the same thing everywhere I go, and that is, very deep concern about the lack of partnership from the Federal Government in terms of funding at this time.

We have local police chiefs and fire chiefs that are not on the same radio frequency in the same town, let alone between cities and counties. We have great communications concerns.

I am sitting with a group of people yesterday who tell me that they are finding out about the increased alert through CNN like we do instead of through other ways.

I am concerned about the lack of training, not only trainers being available, whether it is bioterrorism or other efforts that are needed, but the cost when a police officer or a fire fighter or others go into training, the replacement costs so that officers are there on the streets covering their normal duties, their increased costs of training as well as increased costs for personnel. I am very concerned that we are not stepping up, that we are not partnering with them, and we, in fact, I don't believe are ready—they are working hard. They are working overtime to be prepared and taking on more and more responsibilities. But I know in a State like Michigan, where we are a border State and we have issues of bridges and tunnels and waterways and all of the other issues—drinking water that needs to be protected, drinking water sources, nuclear plants, all of the other things, I am very concerned that we are not providing them the support that they need, and duct tape is not going to do it. We are going to need dramatic increases, I believe, in resources going directly to local communities.

So I share that with you. I know that is not in your international budget. But I have a great concern as I move around the State, obviously not a partisan issue. I am hearing from Republican sheriffs and Democratic sheriffs and people of all stripes and all persuasions, philosophically who are asking for our help. I would ask that you convey that as part of this strategy to be able to respond, particularly as we move closer to war when we know we heighten the possibility of an attack on our homeland.

Secretary POWELL. Thank you very much, Senator.

As you all well know, issues with respect to the Administration and the specific issues you mentioned with respect to training and how to announce alerts and how to communicate that down, and some of the other needs that exist in local communities, I will convey all of that to my colleague, Secretary Ridge, and to the President.

Senator STABENOW. I would just say that we continue to try to pass amendments, pass supplementals as long ago as last July we passed in the Congress a supplemental that went to the President's desk that was not released. So while there may be philosophical differences about whether the Federal Government should play a role in helping local communities fund these efforts, they will not be able to do it without our help.

One other comment in a different vein, Mr. Secretary. I would ask you to step back for a moment, and if you might comment, as we look in a broader view on America's role now as it relates to nuclear threats, nuclear issues and how you would view our leadership on these issues when we start 3 years ago now with the Senate voting no on the Comprehensive Nuclear Test Ban Treaty; the President pulls out of the ABM Treaty. We say that all types of weapons are on the table with Iraq including nuclear, so we are sending one set of messages. Then we have very great concerns about India and Pakistan, about what is happening now in North Korea, which I believe to be extremely serious threats to us. When you put this all together now in the United States of America, what messages are we sending with our own actions, and how do you view the situation in what is clearly a highly disturbing and tense situation as it relates to nuclear proliferation around the world?

Secretary POWELL. There are other messages that I think are just as important, Senator. One is the Treaty of Moscow which is now before the Senate for its consideration, and I hope it gets a 100 to 0 vote which represents a huge reduction in the number of nuclear weapons that the United States and the Russian Federation will have pointing at one another or available to be pointed at one another. I think that sends a signal to the world that the two most important nuclear holding powers in the world are going down with the number of nuclear weapons, not up. I think that is an important signal.

Yes, we did get out of the ABM Treaty, and we did it after long discussion with the Russians. Why did we get out of the ABM Treaty? The principal reason was it was keeping us from defending ourselves against these very weapons that you make reference to. The ABM Treaty prevented us from moving forward on missile defense. Missile defense is for the purpose of destroying these horrible weapons that might come our way or might come at one of our friends and neighbors. Interestingly, after we finally said to the Russians, "Look, we cannot find a solution on this one; we are going to have to withdraw," they said, "Fine. Let's continue to work together on strategic issues. Let's cut the number of offensive weapons." Lo and behold, within the past few weeks the Russians have even indicated more of a willingness than just a couple of months ago to work with us on missile defense because they see it in those same terms.

So the ABM Treaty, rather than encouraging proliferation, shows that proliferators should think twice if they are facing missile defenses that can essentially void the value of your missile.

With respect to India and Pakistan we have been working very closely with both sides, and I think we have played an important role in de-escalating the tension last year. I remember vividly some very long and difficult conversations I had with both India and Pakistan, their leaders, to tell them knock it off with respect to using rhetoric that might suggest that nuclear weapons were a weapon that was usable in this confrontation, and they both did. That situation has calmed down.

With respect to North Korea, we are trying to convey a message to them that says, "You will get nowhere with this kind of activity, this kind of proliferation, because we will not be terrified, we will not be scared, we will not be held hostage by this kind of weaponry. The sooner you understand that you are doing nothing but pursuing fool's gold that will not achieve any political purpose, the better off you will be and we will be, but in the interim, you should know, that we are a strong and powerful Nation and we have all of our options."

It has been part of U.S. declaratory policy for the 50 plus years of the nuclear age that the best deterrent is to simply not talk about what we might or might not do, but nobody can have any thought in mind right now that the United States is thinking of a nuclear option. We are not. There is no need for it in any of the theaters that we have been talking about this morning. But nevertheless, the United States has available within its armed forces a full range of capability and options. It is that full range and what we might or might not do that has served a strong deterrent purpose for the last 50 years, and I think it has served the interest of world peace by people understanding that we have that full range of options.

Senator STABENOW. I appreciate that. Thank you.

I would just say in conclusion that it is very important that our actions—people listen to our actions as well as our words. I think both are being judged. So thank you.

Chairman NICKLES. Thank you, Senator Stabenow.

Senator Ensign.

Senator ENSIGN. Thank you, Mr. Chairman.

Mr. Secretary, I want to start with the AIDS epidemic. There have been some questions asked about that. I met with several of the leaders from African countries last week. We had a round table discussion that Senator Santorum put together to discuss the AIDS problem in Africa. It truly is a calamity. The representative from Kenya talked about the 2 million people in Kenya that are infected with the HIV virus, and out of the 2 million people, or about 2.2 million people I think it was, about 2,000 of them are actually getting treatment. Just doing some simple math it costs about $300 one person. The cost of treatment is down from a few years agon. Just to treat the people in Kenya is $600 million a year. I think that it tells us that there is no way that we have enough money to get everybody on treatment. It is important that we educate as we try to prevent the disease from spreading.

Representatives from Uganda participated in the roundtable discussion last week, and from what I understand the infection rates in that country went from 20 percent down to 6 percent. Recently, they went back to more of their traditional values. They were a monogamous society that had unfortunately gotten into what a lot of the rest of the world has gotten into, the sexual revolution. Because of behavioral attitudes and it is almost all heterosexual—we have seen a dramatic increase in the spread of AIDS.

There are many concerns about the Global AIDS Fund. One, that it is bureaucratic, anf therefore very slow. I have strong concerns about that. Also the governments that you mentioned, in almost every case, it is the local NGO's that actually does the work. It is true that the Ugandan Government was involved in implementing its AIDS prevention policy, but it really was the NGO's that were the most effective. So I would hope that in putting together the Global AIDS Fund that all of these things are taken into account. A lot of us have concerns that this money is going to be wasted, and then there is going to be a backlash against support for the fund. An average American would say "Why don't I get prescription drug coverage instead of you helping out these African countries?" I think that we have the responsibility to help in the global fight against AIDS as long as we are being good stewards of those hard-earned tax dollars provided by the American people.

I have a question on the HIV front—right now we are being told that the Mexico City language does not prevent AIDS money from—there is no Mexico City language associated with the AIDS money. It only is associated with family planning, population control money. We are getting reports that indeed, because money is fungible, a lot of the people who are providing abortions overseas are using the AIDS money we provide for abortions. Could you make a comment on that?

Secretary POWELL. Yes, sir. As a matter of fact, in the very near future we will be meeting within the Administration to examine the various new programs, Global AIDS Fund, but especially the new Emergency Plan for HIV/AIDS. Balancing it against other policies such as the Mexico City policy to make sure that we have a consistent approach across the whole administration. I am aware of your concern, and we will be meeting on that within the next few weeks.

Senator ENSIGN. I appreciate that because there are many of us up here in Congress that would like to put the restraints on the spending to make sure that we are not going to fund abortion around the world.

I want to ask a question though on North Korea, switching gears just a little bit. It seems to me that the reasons to identify how we have gotten to where we are in North Korea is not to place blame, but to prevent this in the future—we need to learn from the past. It seems to me that the way that you are dealing—and I congratulate you and the whole administration on how you has handled the Iraq situation and the global war on terrorism. I believe that if you study history, dictators do not respond to diplomacy. Very rarely do they just respond to talking. A lot of them, especially the ones that are the evil dictators of the last century, and certainly the ones that we have around today respond to strength. They respond if there is something at stake.

In North Korea we have one of those dictators. How did we get in this situation? What mistakes were made during the 1990's that led us to this situation, and, if we have a country like North Korea in the future, how can we assure that we do not make the same mistakes.

Secretary POWELL. North Korea certainly does understand America's strength. In fact they are very fearful of America's strength, and we have made it clear to them that we have all of our options, but it is not necessary right now, as we are trying to find diplomatic solutions, to sort of beat them over the head with it. They know what we have and they know what we can do.

Senator ENSIGN. I agree with that.

Secretary POWELL [continuing]. North Korea knows that it cannot win a war on the Korean Peninsula, but they sure can create a lot of havoc and they can destroy a lot of people and destroy quite a few cities, especially the city of Seoul in the process. So we both have a good understanding of what the other can do.

North Korea elected to use a route of missile proliferation and weapons of mass destruction programs to give itself more strength and authority on the world stage than it would have otherwise on the basis of its economy or its system. I think in the course of the last decade or so, as these programs became more obvious, attempts were made to capture these programs and to eliminate them over time. At the same time you are not precipitating a crisis or a war on the Korean Peninsula that nobody wanted, especially the South Koreans. We have to be especially mindful of the views of our South Korean friends. They are interested in unification with their brothers. The Korean people are very homogeneous. They want to be one Nation again. No Korean leader will ever be elected to the leadership in South Korea without a commitment to ultimately bringing the two peoples back into being one people, so they are not anxious to see a conflict.

So efforts were made over the last 10 years to remain strong, keep our presence in Korea, watch that army of theirs, but at the same time find ways to corral these programs, eliminate them, bring them under control. The previous administration worked hard on it. I give them credit, and not at all criticism on my part. They worked hard to control what was going on at Yongbyon, and they brought it under control, but unfortunately, they were not able to eliminate that capacity, but they brought it under control. The capacity to restart it remained, and it was not going to go away under the Agreed Framework until the light water reactors were up and running. Only then would the cells be removed and sent off somewhere else for storage and destruction and made safe.

Unfortunately, the previous administration had no way of knowing, nor did we—we were in the same boat as the previous administration when we came in—that the North Koreans had the ability to move in another direction with respect to nuclear weapons, because they frankly, I guess, saw the value of nuclear weapons. They saw how they could extract things from the rest of the world by saying they were moving toward nuclear weapons, and so they did not want to give away the card that everybody thought they had at least pushed off to the side.

So when we found out about it, we had to call them on it. The solution we are going to find this time has to be a solution that deals with it once and for all.

Senator ENSIGN. If I may interrupt just for a second. I want to go back though because we need to learn from this. I understand not wanting to encourage a war, but it seems to me that we tried to appease his father, and now we have a second generation of madmen in North Korea. The agreement was broken, and North Korea continued to develop weapons of mass distruction with the means to misuse, while the U.S. paid them not to do so. Any agreement now must include proper verification measures.

Secretary POWELL. This was a major concern that we had when we came into office, and that a number of the arrangements that had been made were lacking in verification. The previous administration understood that as well, and in our transition conversations between my team and the outgoing team, we talked about the need for verification, and that is why their efforts have not moved even more rapidly along, because they could not sort of crack this nut with respect to verification and assuring that no more technologies would be sold.

But on the handoff we were more skeptical, and we wanted to make sure we knew what we were doing and took our time to review our policies. But at the same time we still think there is the potential for diplomatic solution. What we will not do, and what a lot of people are pressing us to do, but we are going to resist the pressure, is suddenly say, "Just tell us what you want, tell us what you want just to get this problem off the table, and then we will give you whatever you want." That is not the best way to solve this problem. It is not going to be our approach.

Senator ENSIGN. I totally agree.

Chairman NICKLES. Senator Ensign.

Senator ENSIGN. Can I just conclude with this, Mr. Chairman?

It is such an important lesson for us to learn, the danger of nuclear weapons of mass destruction, in the hands of somebody like this. I think that we need to learn from the past that it is virtually impossible to verify with a dictator like this. So empowering them just to avoid a situation at the time is a very dangerous thing for us to do. I think it was wrong at the time. I think you can look back on those situations and say, "It was a mistake. We should not make these agreements in the future because once weapons of mass destruction are available to a country like North Korea, the situation becomes much more dangerous and much more difficult to control with in the future."

I thank you for your indulgence.

Chairman NICKLES. Senator Ensign, thank you very much.

Mr. Secretary, I was hopeful that we would be able to get you out of here by 12. I think we have at least three senators, maybe four. Can you go another 15 minutes?

Secretary POWELL. Yes, sir.

Chairman NICKLES. I will ask my colleagues, try and be mindful, and I probably should have been rapping the gavel a little earlier.

Senator MURRAY.

Senator MURRAY. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for your very informative and candid discussion today. I wanted to talk about foreign assistance programs because I really think that the case needs to be made that each military threat facing our country is really first a foreign policy issue, and it is not enough to address the threats to this country solely through our capacity to respond militarily, but we need to do more on the foreign policy side as well. I was struck by a statement that Senator Lugar made last week in a Foreign Relations Committee. He said that the United States spends 8 cents on foreign policy for every dollar that goes to defense. I am curious if you could share with us what you think might be the appropriate ratio with your background for these two functions.

Secretary POWELL. I do not think it is appropriate to compare Foreign Operations funding with Defense funding or Foreign Operations with Social Security or any other function. I think it can stand on its own merit. I think eight cents compared to a dollar for the Pentagon is not the right comparison. The fact of the matter is only about one percent of our Federal budget is allocated to this function. I would like to see it be a lot more, but as a result of the priorities that we have and the resources available to the Congress and to the President, I am pleased that President Bush has been able to increase it every year that he has submitted a budget, and he has taken some dramatic steps with respect to the Millennium Challenge Account, which is a 50 percent increase in what we had been doing previously with respect to development assistance, and what he has now done with the Emergency Plan for HIV/AIDS is another significant increase, and so we are doing a lot better with respect to our commitment to these kinds of programs. I would like to see it be a lot more because the needs around the world are great. Senator Ensign was talking HIV/AIDS. He described it as a calamity. That is certainly true, but it is far more than a calamity. It is an absolute catastrophe on the world stage that we have to do something about; poverty, famine, they all interact. People who are hungry are more susceptible to the diseases that flow from HIV/AIDS and then go into malaria and tuberculosis. So I would like to see us do a lot more. I would double and triple it if I were king for the day.

But I recognize that the President has to shape his budget in accordance with a large number if priorities and the Congress has to do the same thing, and so I hope that you will fully fund the President's request, and that is the best I can do, support the President's request.

But obviously, if the President has requested more, I would be even more pleased.

Senator MURRAY. Well, thank you for that. I know that without question the war on terrorism is a top priority for this country, but that is what I am having a little bit of trouble with the President's budget and rhetoric on our assistance programs. In your testimony you said this budget contains 4.7 billion for countries that have joined the war on terrorism, and I think there is no question we should not work with countries as you have done, Pakistan, Turkey, Jordan. It is in our national interest obviously, but is this assistance really foreign assistance, helping people in the traditional sense of health or education or democracy? It seems to me, if I look at this, the budget really significantly redirects foreign assistance to the war on terrorism, so I am kind of troubled by your assertion that the budget increases foreign assistance funding.

By taking $4.7 billion away from other foreign assistance initiatives are we not really reducing our foreign assistance globally?

Secretary POWELL. No. It is for all kinds of assistance. It is not simply for terrorism activities. It is for a variety of assistance efforts in these countries that have been particularly helpful on the war on terrorism. The Millennium Challenge Account, that additional, that 50 percent increase in the budget.

Senator MURRAY. Is that part of the 4.7?

Secretary POWELL. No, separate. It is on top of the $4.7 billion. For this year it is $1.3 billion for the Millennium Challenge Account to get it up and going and running.

Chairman NICKLES. Senator Murray, thank you very much. If you do not mind, I would like to move kind of quickly.

Senator CORNYN.

Senator CORNYN. Thank you, Mr. Secretary, for being here. I appreciate your long-time exemplary service on behalf of the Nation, and I just, particularly at this time I wanted to say that.

But quickly I have one question. Really it relates to our relationship with Mexico. As you know, we have a very important relationship based on geography and history and culture, and I was gratified when the President, the first international trip he took after he became President was to see President Fox in Mexico. I am a firm believer in the need to deepen and improve our relationship, strengthen our relationship with Mexico. I would like to work with you and your department on that.

But I am very concerned about Mexico's failure to live up to an international treaty that was passed in 1944 governing the distribution of vital water resources, and particularly disturbed by Mexico's most recent failure to abide by an interim agreement which at least promised some hope to South Texas farmers, and that interim agreement called for the delivery of 200,000 acre-feet by the end of January. Unfortunately, at that time there was no schedule for the repayment of the remaining 1-1/2 million acre feet, but for those who like to be optimistic and hopeful, that at least it offered some hope. Now we know Mexico has delivered only 129,000 of that 200,000 acre-feet, even under that interim agreement on January the 31st. I have to tell you that particularly folks in the agriculture business in South Texas have been devastated by Mexico's failure to live up to this obligation. It has had a ripple effect in our economy. Over a billion dollars has been lost over the last 10 years due to the failure to abide by the treaty.

So some have, in their frustration, voiced several options that they think the United States ought to consider. One would be possible sanctions against Mexican agricultural produce grown by the very water that they feel should have been delivered under the treaty, but which has not been. Second, possible renegotiation of the Colorado River Treaty that actually sends Colorado River water to Mexico. Third, to just terminate the treaty entirely, just to walk away from it.

I would appreciate your thoughts on Mexico's failure to abide by the interim agreement, as well as the negotiations, which I believe are occurring even today in San Diego on this matter.

Secretary POWELL. We are very disappointed that Mexico has been unable to meet its obligations under the 1944 treaty and there is such a backlog of 1.5 million acre-feet. The interim agreement to provide 300,000 acre-feet for this growing season we thought was an important step. They have been working hard to try to fix this problem. The President raises it with President Fox in every conversation. I raise it with my Mexican colleagues in every conversation. It was the subject of considerable discussion when we had the Binational Commission meeting in Mexico City in December. At the time they said they would be coming forward. So they made a commitment to 300,000 acre-feet, but as you know, Senator, they only provided the 129,000 or 130,000 acre-feet that you made reference to. We are pressing them very hard, trying to get another increment right away of 55,000, trying to get back up to their obligation for the 300,000 acre feet for this growing season.

We will continue to press. As you noted, they are meeting on it now. There are often technical debates as to how much water is or is not in a particular reservoir, or set of reservoirs in Mexico, but it receives the highest level attention from our government. I would try to avoid the sorts of remedies that you described, Senator, either a boycott or embargo on certain quantities of goods coming from Mexico, or abrogation of the 1944 Treaty, or redoing the Colorado River Agreement, and let us continue to pound away to see if we cannot get them to meet the commitments they made for this growing season, as a start toward resolving ultimately the 1.5 million acre-foot backlog.

Chairman NICKLES. Senator Cornyn, thank you very much.

Mr. Secretary, thank you for that. We have two additional senators that wish to speak. I will call on Senator Allard. Mr. Secretary, I apologize. I need to step out, and then after Senator Allard, it is Senator Bunning.

Senator Bunning, if you would be kind enough to wrap up the hearing.

Just for notification of our colleagues, the next Committee hearing will be on Thursday with Michael Jackson to discuss transportation, Deputy Secretary of Transportation.

Mr. Secretary, I apologize, but I need to leave.

Secretary POWELL. No, I fully understand.

Chairman NICKLES. But this has been an outstanding hearing. Your presentation last week—I complimented you on it a couple of times—was outstanding, and also your presentation today has been superb. So thank you very much.

Secretary POWELL. Thank you, Mr. Chairman.

Chairman NICKLES. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I would also reiterate what some of my colleagues already said, at least on this side since I have been here, I think you are doing a great job. I think you are an important part of the Administration team, and so I have a great deal of respect to the way you are conducting yourself on foreign affairs.

I understand that you are engaged in discussions with the Government of Israel over the possible U.S. multi-year assistance packages that consists of loan guarantees as well as some military aid. This is to try and address the current economic and security crisis we have there in Israel. I wonder if you would share with me briefly the feeling from the Administration—apparently they have been somewhat supportive—and has there been any thought about when this money may be made available, and when you might be making requests?

Secretary POWELL. We have been in intense discussions with the Israelis, and we are familiar with their needs, really sensitive to the needs of our Israeli friends. No decision yet is forthcoming with respect to the amount that we will be able to provide, and no commitments have been made to Israel yet, and so we do not have something to put before the Congress at this time.

Senator ALLARD. The other brief question I have concerns the Millennium Challenge Account. It brings forth a lot of concepts, I just wonder why are they not being addressed in the agencies we already have? So I would like to know just what your thinking is, why you felt like it was necessary to set up a new separate agency and why the current agency structures you have cannot address some of your problems, and if you could share some of that thinking with this member, I would appreciate it.

Secretary POWELL. Thank you, sir. The Administration, especially the President of course, felt very, very strongly that the Millennium Challenge Account should not be just seen as aid in the old traditional sense. He wanted a specific program that encouraged democracy building, infrastructure building, the end of corruption in development nations, a rule of law, transparency, economic development, education, and he wanted to reward those countries that have made a solid political commitment to that end. New democracies, emerging democracies, perhaps even older democracies that now firmly put their path on completing the democratic transition and to getting into a globalized 21st century world, where they had to take care of their people and had to prepare their people for the demands of the 21st century world. Very often our usual USAID programs deal with needs that may be related to one of these kinds of countries or not, may be related to a country where there is a specific need. But he wanted it to be new and different and focused on that kind of capacity building.

Senator ALLARD. So this is much more proactive. The other ones, they kind of comes after the fact. This is a more——

Secretary POWELL. Yes, it sometimes comes after the fact and it really is sort of need based as opposed to having this specific dynamic to it, to encourage these kinds of countries. In order to make sure that everybody understood that clear message, he felt it best to do it through an independent agency which we are in the process of setting up now.

Senator ALLARD. Thank you very much for your comments.

Secretary POWELL. Thank you, Senator.

Senator BUNNING. [Presiding] Mr. Secretary, thank you for being here. I am sorry that I was at a prior meeting on the Banking Committee, some of us were.

Let me ask you just one question, and get you out of here. First of all, congratulations on your speech at the United Nations. I thought it was targeted and right directly to what we needed to do, and I am very proud of it.

Secretary POWELL. Thank you, sir.

Senator BUNNING. In the past years the U.S. has, to some degree, tied economic assistance to Egypt to that country's willingness to make economic reforms that will move it closer to a free market economy. Could you address what assurances, if any, that the United States has asked from Egypt that they will engage in political reforms that will move them toward a greater democratization?

Secretary POWELL. We try to encourage Egypt in every way that we can to undertake economic reforms we believe are needed within that country to make its economy more viable and to do a better job of taking care of its people. With respect to specific programs and specific initiatives that we have used over the years to do that and we are using now, I would like to provide you a more fulsome answer for the record. But certainly we encourage them, push them, discuss with them, and use our embassy team in Cairo to given them ideas as to things that they can be doing and should be doing in order to make their economy more productive and to make better use of the aid that we are providing to them.

Senator BUNNING. If you would follow-up with a written response, I would appreciate that.

Secretary POWELL. Yes, I would like to give you some more specifics. There are some new and exciting things we have been doing, and there has been some progress in Egypt that I would like to report for the record.

Senator BUNNING. Kent, would you like to?

Senator CONRAD. I would, if you do not mind, Mr. Secretary, just a final question. We are often advised to hope for the best and prepare for the worst. What would you advise us is the worst case situation we might confront with respect to Iraq and North Korea that this Committee should be prepared to deal with? If you were looking ahead, what are possible outcomes, possible consequences that we should be especially sensitive to?

Secretary POWELL. I hope the Committee, with respect to Iraq, will be sensitive to the needs that might immediately exist if a conflict were to come, if we are not able to avoid a conflict. There will probably be immediate needs to assist the Iraqi people in provision of food, provision of other humanitarian needs. In due course they will be able to take care of themselves because they have the money, but the system may be shaken so badly initially the Oil for Food Program may be thrown into disorder. So that the Congress, I hope, would support us in any emergency supplemental requirements we have to take care of the people of Iraq until such time as we can get their systems back in place and running.

Senator CONRAD. Do you have any sense of what the size of such a supplemental might be?

Secretary POWELL. No, sir. I could not even begin to speculate, but I want to assure you, sir, and the Committee, that there is an enormous amount of work being done within the Department of State, Department of Defense, where an office has been created to work on this, and will look at all of the issues having to do with humanitarian needs, medical needs, how to protect the oil fields of Iraq for the benefit of the Iraqi people.

This canard that is constantly being tossed out, that all we want is their oil. The oil of Iraq belongs to the people of Iraq, and we will help the people of Iraq use that oil for their benefit and not to threaten their neighbors. That is not only a matter of principle, it is a matter of international law if we go in there. I cannot at this point though give you an estimate of any supplemental needs that would be required.

With respect to North Korea, the only thing I would suggest at this point is that the Congress support us in our diplomatic efforts, and that we be given a little bit of room to maneuver, and that there is some patience shown. It took 14 months for the last agreement to be dealt with back in the 1990's. We are not intending to have a similar process or a similar agreement, but these things take time. Diplomacy does not always produce instant results, but very often produces good results, and I hope we will have a good result there.

Senator CONRAD. Thank you very much for your testimony here this morning.

Senator BUNNING. Thank you, Mr. Secretary.

Secretary POWELL. Thank you, Senator.

Senator BUNNING. We appreciate you being here.

Secretary POWELL. Thank you.

Senator BUNNING. We are dismissed.

[Whereupon, at 12:10 p.m, the committee was adjourned.]

Brief Statement
February 11, 2003

Thank you, Mr. Chairman.

First, let me say welcome and thank you to Secretary Powell for testifying before the Budget Committee today. As a member of the International Operations and Anti-terrorism Subcommittee and one of two U.S. Congressional Delegates to the United Nations, I have a particular interest in Secretary Powell's testimony. I have been seeking and pushing for space for a liaison office for the State Dept in the Senate Office Building.

Over the last several years, I have become engaged in all aspects of foreign affairs. Last year, I traveled to Russia to meet with members of the Russian State Duma and Federation Council about forming a working legislative group that would help bridge the gap in our export control policies and develop cooperative approaches in stemming the proliferation of weapons of mass destruction.

As a strong proponent of improving our export control system for both dual-use and military items, I believe it is absolutely critical that we work with our friends and allies to strengthen multilateral export control regimes and establish similar legislative thresholds for export control systems.

I also recently traveled to Brazil, where I took part in the inauguration of their new President and met with legislative leaders. Both of these experiences within the last year have allowed me to see the efforts of the State Department from the front line. Further, it has allowed me to have a better understanding of the important work you do as the first line of defense, or offense as you remarked in your statement, in combating terrorism and other national security threats.

With that, I would like to get into my first question. Secretary Powell, as you know , Senator Sarbanes and I serve as the U.S. Congressional Delegates to the United Nations. As such, I have made several trips to New York and have seen first-hand the disrepair of the UN Secretariat Building. I have prepared a written statement that further explains the unsafe conditions of the building, and would ask that it be included in the record by unanimous consent.

Statement on United Nations Capital Master Plan
Senator Michael B. Enzi
February 11, 2003

Two years ago the United Nations Secretariat issued a report on plans for a much needed renovation of the Secretariat building in New York. Before that report and subsequent General Accounting Office (GAO) reports, few people outside the UN knew about the dangerous situation in the building.

I have seen first-hand that the United Nations Secretariat building in New York is in dire need of repair. The safety of each and every employee and diplomat is threatened by the current conditions of the site. The United States ensures the safety of domestic employees through the Occupational Safety and Health Administration but the UN building couldn't pass a basic OSHA inspection. UN employees are Americans, Indonesians, Brazilians, Egyptians, Kenyans, Russians – citizens from every nation in the UN. The Secretariat building is a truly international community and the entire community is at risk.

The fire alarm system is not only antiquated and inadequate, but false alarms have become so common that employees have learned to ignore the system. There is no sprinkler system. There is even the possibility that a fire engine could fall through the front parking lot because of poor structural support.

Thousands of people are working in a building with one small evacuation tunnel – a tunnel without the capacity to evacuate a small percentage of the daily occupants. Desks are routinely situated next to walls with exposed asbestos. The heating system was once advanced, but that was 50 years ago.

Were this a private entity, it would be immediately evacuated and deemed unfit for human occupation. Instead, a diplomatic body, with world leaders coming and going, is housed in a building that falls far below today's safety and security standards – far below the standards for any other building in New York City.

Having the headquarters of the United Nations in the United States is an honor and a symbol of our relationship with and in the United Nations. I believe the United States must show our interest in renovating the Secretariat building and increasing the safety for those who work there.

This is not an issue of expansion of the United Nations and it certainly is not about building a new tower for the UN. This is an issue of safety, an issue of security.

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON THE BUDGET
FY04 Foreign Affairs Budget Request
February 11, 2003

THANK YOU, MR. CHAIRMAN.

MR. SECRETARY, I APPRECIATE YOU TAKING THE TIME TO BE WITH US TODAY TO DISCUSS THE PRESIDENT'S FISCAL YEAR '04 BUDGET REQUEST FOR INTERNATIONAL AFFAIRS. I REALIZE THAT THERE ARE MANY DEMANDS ON YOUR TIME IN THESE PRESSING DAYS, BUT I KNOW THAT YOU VALUE THE IMPORTANCE OF THESE EXCHANGES WITH CONGRESS.

AS YOU WELL KNOW, IT IS IMPERATIVE THAT THE MEMBERS OF THIS COMMITTEE HAVE THE BEST INFORMATION POSSIBLE AS WE CONSIDER THE IMPORTANT DECISIONS THAT WE HAVE IN FRONT OF US.

I LOOK FORWARD TO HEARING MORE ABOUT THE NEW INITIATIVES SUCH AS THE MILLENNIUM CHALLENGE ACCOUNT AND THE MIDDLE EAST TELEVISION NETWORK THAT THE PRESIDENT HAS PROPOSED AS WELL AS THE ADMINISTRATION'S PLANS AND PRIORITIES FOR FOREIGN AID AND THE WAR AGAINST TERROR.

I ALSO HOPE THAT A DISCUSSION OF THE SAFETY OF OUR OVERSEAS FOREIGN SERVICE AND STATE DEPARTMENT PERSONNEL WILL BE INCLUDED IN TODAY'S HEARING.

AGAIN, THANK YOU MR. SECRETARY FOR APPEARING HERE TODAY TO ENGAGE IN THIS DIALOGUE WITH THE COMMITTEE. WE ALL HAVE A YEAR OF TOUGH CHOICES AHEAD OF US AND I LOOK FORWARD TO WORKING TOGETHER AS WE FACE THE CHALLENGES.

THANK YOU.

Question for the Record Submitted to:
Secretary Powell by
Senator Bunning (#1)
Senate Committee on the Budget
February 11, 2003

Question:

In past years, the U.S. has, to some degree, tied economic assistance to Egypt to that country's willingness to make economic reforms that will move it closer to a free-market economy. Could you address what assurances, if any, the U.S. has asked from Egypt that they will engage in political reforms that will move them toward greater democratization?

Answer:

During its September 2002 conference, Egypt's National Democratic Party adopted a policy document that advocated for movement toward a more open, democratic society with increased public participation. We support the strengthening of democratic institutions in Egypt and are working with the Government of Egypt to ensure that our assistance furthers that objective.

Under the Middle East Partnership Initiative (MEPI), we are developing programs throughout the region that will focus on three areas: economic reform, education, and democracy and civil society. These are areas to which we plan to devote significant resources over the coming years. The Initiative also encompasses our existing economic assistance programs in the Arab World. We are reviewing all of these programs beginning with our program in Egypt. The review is focused on ensuring that we are reaching as many Egyptians as possible with our aid; that our programs deliver assistance efficiently; that our funds promote the reforms targeted by MEPI; and that we improve our measurement of results. In Egypt, we anticipate that, as part of this review, we will be spending a larger portion of our assistance resources on programs that encourage economic, educational, and political reform. The Egyptian government supports these new areas of focus.

Question for the Record submitted to:
Secretary of State Colin Powell by
Senator Bunning (#2)
Senate Committee on the Budget
February 11, 2003

Question:

I understand that the CBO has estimated that six months of peacekeeping, with 75,000 to 200,000 troops, could cost $8-23 billion. Could you comment on this figure and is it in line with internal estimates at the State Department?

Answer:

The State Department does not have any estimates on peacekeeping costs at this time.

Questions for the Record submitted to
Secretary of State Colin Powell by
Senator Bunning (3)
Senate Committee on the Budget
February 11, 2003

Question:

Could you comment on what the United States is doing to insure that UN organizations reflect U.S. policies when spending U.S.-provided funds? Do we ask for any accounting of U.S. funds from UN organizations?

Answer:

Representatives of the United States work hard to maximize U.S. national interests throughout the UN, its organizations, and UN conferences. The goal is the achievement of UN priorities and practices that reflect policies and standards of the United States to the maximum extent possible.

The level of U.S. contributions to the UN and its programs/agencies helps us exert a strong leadership role in the UN bodies that determine policy, procedures, and implementation of those programs we help fund. We also promote Americans for as many official roles as possible within the UN system in order to exert influence through them.

Approximately half of the U.S. contributions to the UN System goes toward U.S. assessments for the UN regular budget, UN peacekeeping, and the budgets of the specialized agencies; the other half goes toward a variety of UN programs dependent on voluntary support, mostly in the humanitarian area. U.S. assessed contributions and most voluntary contributions are not earmarked; our share (22% in the UN and most other assessed agencies) is commingled with the shares from other members.

However, we carefully review UN expenditures by monitoring the work of its Board of Auditors, and we look for waste, fraud, and abuse through the work of the Office of Internal Oversight Services, which the U.S. was instrumental in creating. In the other agencies, we also review both external and internal audits to ensure that expenditures reflect agreed-upon policies. Further, for the agencies and programs that rely on voluntary contributions, we base our contribution decisions on whether and to what extent we believe their programs conform to or support U.S. policy.

UN Peacekeeping Operations

With the U.S. covering some 27% of the UN's peacekeeping budget, it is extremely important that UN peacekeeping reflects U.S. priorities. We ensure this in several ways above and beyond the omnipresent power we have to veto resolutions we find unsuitable. First, we have worked with the UN to improve efficiency and cost-effectiveness in peacekeeping operations. Our presence on the UN's ACABQ (budget committee) has given us influence over the examination and evaluation of peacekeeping mission budgets. We also pressed successfully for the creation of an Inspector General for Peacekeeping Operations to aid in the elimination of waste and to improve missions' performance.

One of the main tools to improve efficiency and operation of peacekeeping operations has been the report of the Panel on U.N. Peace Operations (Brahimi Report), which offered suggestions for improvements in the UN's Department of Peacekeeping Operations. Improvements in accountability, preparedness, and staffing mean that peacekeeping operations are becoming more effective. With these advances, operations are less likely to remain permanent fixtures in a conflict; in fact, in 2002 the U.N. shut down two peacekeeping operations that had completed their mandates (the UN Mission in Bosnia and Herzegovina and the U.N. Mission of Observers in Prevlaka).

The presence of U.S. personnel on the ground in many missions, including in many leadership positions, ensures that we are represented as a mission carries out its mandate. In addition, this allows us to get good information on how the reality on the ground compares to information submitted to the Security Council.

One example of U.S. influence in the process is recent activity having to do with the UN peacekeeping operation in the Congo (MONUC). When the UN proposed enlarging the mission, the U.S. held discussions with UN staff and Security Council members preparatory to renewal of the MONUC mandate in June 2002. We noted that a number of conditions set out for moving into Phase III (disarmament, demobilization and repatriation - DDR) operations had not been met. There had been no dialogue between Congo and Rwanda on coordinating and establishing a framework for DDR. A suggested increase in troop strength was turned back; the US noted that MONUC remained more than 30% below its authorized ceiling due to lack of willing troop contributing countries, and that redeployment as Phase II tasks ended could allow MONUC to move forward into Phase III activity without additional troops.

In late July 2002, Congo and Rwanda signed an agreement calling for the Congo to assist dismantling of Rwandan Hutu rebels in its territory and for Rwanda to withdraw its forces. Once the Rwandan forces withdrew, in October, State [IO/PHO] consultations with Hill staff led to agreement on specific objectives ("benchmarks") for

Phase III activity which were included in UNSC Resolution 1445 (adopted December 4, 2002). Although the resolution allowed an increase in troops, U.S. pressure ensured that this would be phased, with conditions for additional deployments listed in the resolution.

Counterterrorism:

In FY 2002, the U.S. contribution to the UN was extraordinarily cost-beneficial, as resolution after resolution was passed reflecting U.S. goals in the war against terrorism. UNSCR 1377 called on member states to implement fully UNSCR 1373, which included (among others) the requirement that terrorist assets be frozen. The Resolution also invited the UN Counterterrorism Committee (CTC) to explore ways in which member states could be assisted, and U.S. and international experts have and are helping many countries develop systems that could discover, track, and ultimately freeze assets that could support terrorist activities. The CTC has received 179 "first round" reports from countries detailing counter-terrorism measures in place or planned, all indirectly promoting U.S. national security interests.

Since UNSCR 1373 was adopted, a large number of states have revised or upgraded their legal frameworks, and the pace of countries joining the 12 international conventions and protocols relating to terrorism has increased. The CTC now expects countries to have in place effective and coordinated executive machinery covering all aspects of UNSCR 1373 -- in particular, preventing recruitment to terrorist groups, movement of terrorists, the establishment of terrorist safe havens, or any other form of active or passive support for terrorists.

An International Atomic Energy Agency (IAEA) nuclear counter-terrorism plan, incorporating U.S. priorities, was approved and implementation began. The Universal Postal Union (UPU) and IAEA have reached agreement on procedures for limiting and protecting radioactive materials sent through the post.

The International Civil Aviation Organization unanimously approved a resolution condemning terrorism and initiated a program of auditing member state compliance with ICAO security standards, addressing U.S. security concerns.

The International Maritime Organization (IMO) is moving toward agreement on placing transponders on all ships so that their movements can be tracked and they can transmit an alert in case of hijacking.

The International Labor Organization (ILO) is working with IMO on more secure ways of identifying legitimate seafarers, which will facilitate their screening for admission into the U.S. while in port.

The World Health Organization supported our position and decided not to destroy the declared stocks of smallpox virus, in order to continue research on smallpox vaccines and anti-virals.

UNESCO -- the UN Educational, Cultural, Scientific and Cultural Organization -- condemned terrorism after 9/11, even though the U.S. was not a member during FY2002. The Director General also announced UNESCO's intention to conduct a program review to re-orient activities to promote the observance of human rights, dialogue, and the concept of tolerance. In this case, the hope of U.S. re-entry, with the funds that includes, probably helped influence UN organization behavior.

Regional Stability:

The UN Security Council, with our guidance or at least approval, addressed regional conflicts in the Middle East, Africa, Iraq, Afghanistan, East Asia, the Balkans, and the Caucasus in FY2002. We believe our leadership helped ensure successes for the UN Mission in Ethiopia and Eritrea, where the Boundary Commission announced delimitation of Ethiopia/Eritrea border; the UN Mission in Sierra Leone, where 45,000 combatants were disarmed; and for the UN Transitional Administration in East Timor (UNTAET), which was replaced by a scaled-down UN Mission of Support in East Timor (UNMISET), presidential elections were held, East Timor became independent, and East Timor became a UN member state.

In the Democratic Republic of the Congo, UN forces were redeployed east after Rwandan troop withdrawal; planning began for disarmament, demobilization, and repatriation in the east under UNSCR 1445. The UN Assistance Mission in Afghanistan was established pursuant to UNSCR 1401; civil war in Angola ended, marked by the conclusion of the UN-chaired Joint Implementation Commission; an agreement was reached in July to terminate by the end of 2003 the UN Mission in Bosnia and Herzegovina; and the Secretary General's settlement plan for Cyprus was announced.

Organizational Reform:

U.S. priorities from the Helms-Biden legislation are reflected in UN reforms, as reported to Congress over the last two years. In December 2001, the General Assembly approved the first results-based budget for the United Nations, a priority for the United States and other members of the Geneva group who pay over 80 percent of the total UN budget. The United States continues to press for implementation of sunset provisions for new UN programs. On December 24, 2001, the groundwork for future reform was laid when the UN General Assembly requested the Secretary-General to conduct a series of comprehensive reviews of critical activities, such as the Department of Public Information and the Department of General Assembly Affairs and Conference Services.

Weapons of Mass Destruction (WMD):

Until very recently, successes in advancing U.S. goals of eliminating weapons of mass destruction through UN organizations were obvious. Even with the determination that the Iraq regime remained in material breach of UN resolutions and had to be disarmed by force, U.S. funds that went toward the payment of inspectors, for instance, have helped develop the expertise and procedures that will undoubtedly be useful in a post-Saddam Iraq and other hot spots in the world.

Some of the 2002 UN successes that reflected U.S. policy in WMD included development and adoption of the revised Goods Review List, commonly thought of as the Iraq sanctions. This list controlled Iraq's importation of all the items known to be of possible use in the development of weapons of mass destruction. In November 2002, at U.S. urging, the UNSC unanimously adopted UNSCR 1441, providing for a strict new inspections regime, while noting that, if Iraq did not comply with its obligations, it would face serious consequences.

In November 2002, the IAEA issued a strong resolution reflecting U.S. policy on the North Korean nuclear program, sending a clear and unmistakable message that the international community will not tolerate a North Korean nuclear weapons program. The IAEA implemented an action program to counter the threat of nuclear terrorism with enhanced activities in the physical protection and security of nuclear materials and facilities, and the detection of and response to malicious activities involving them.

Democracy and Human Rights:

The U.S. was re-elected to the UN Commission on Human Rights (CHR) for the term starting in March, 2003. Despite not being a member in 2002, the U.S. was able to influence the Commission and Resolutions condemning Cuba and Iraq for human rights abuses still passed.

The Sierra Leone Special Court on war crimes was established in January 2002, an American has been appointed as prosecutor, staff installed, judges sworn in; and very recently the first indictments were issued. The International Criminal Tribunal for the Former Yugoslavia and the International Criminal Tribunal for Rwanda continue prosecutions.

Open Markets:

The U.S. was active in First World Summit on the Information Society (WSIS) PrepCom in Geneva. The Bureau's efforts ensured that non-governmental organizations will be able to participate in WSIS. The U.S. worked to keep WSIS themes focused, with some success, although the WSIS agenda is expected to expand. The U.S. is utilizing international organizations to resist attempts to develop international regulation of cyberspace, while promoting cybersecurity and freedom of expression.

The U.S. slate of reforms for the World Intellectual Property Organization (WIPO) Patent Cooperation Treaty (PCT) continues to be fully debated within the PCT Reform Working Group and Committee. The standing Committee on Patents continues to discuss a draft substantive patent law treaty. U.S. participation in these international organizations is essential to protection of U.S. market interests.

Economic Development:

The long, skilled work of the U.S. delegation helped the U.S. lead the Financing for Development Conference to adopt the Monterrey Consensus in 2002. This Consensus reflects U.S. policy, placing domestic resource mobilization and responsibility at the heart of development financing, with emphasis on good governance and sound economic policy.

The 2002 spring meeting of ECOSOC, World Bank and IMF, following the Monterrey Conference and the adoption of the Monterrey Consensus, was the first such meeting to discuss Monterrey Consensus implementation and follow-up issues. It is the understanding of the ECOSOC, World Bank and IMF that the annual spring meetings will take up Monterrey Consensus implementation-related issues.

The UN General Assembly macroeconomic and development-related resolutions have adopted Monterrey language and also adopted resolutions on Monterrey follow-up. The World Summit on Sustainable Development (WSSD) in Johannesburg remained consistent with Monterrey and endorsed both Monterrey and Doha. The WSSD provided consistent mandates for UN development activities focusing on improved economic policies and on effective partnerships that link sector-specific activities to developing country policy and regulatory frameworks. Without U.S. leadership, it is unlikely that any of these documents would have reflected U.S. positions clearly. More likely, the documents would have tried to place unreasonable financial obligations on the "first world" countries instead of encouraging self-sustainable development.

Humanitarian Assistance:

Through the UN Inter-Agency Standing Committee Task Force, the U.S. has taken the lead in getting codes of conduct in place against sexual exploitation by humanitarian workers. Frequency and quality of contacts with the UN Office for the Coordination of Humanitarian Affairs (OCHA) improved, especially in regard to coordinating post September 11th relief activities in Afghanistan. The State Department minimized disruption of the World Food Program (WFP) and UNHCR relief activities inside Afghanistan that could have occurred during Operation Enduring Freedom, through liaison with CENTCOM and the UN in New York.

Blueprints for specific services dealing with infectious diseases and early warning were developed by the U.S. and presented at the Global Disaster Information Network (GDIN) annual conference in June. Informal GDIN partnerships have increased and a plan for formalizing and expanding partnerships and information were also presented and accepted at the conference.

The U.S. and Office for Coordination of Humanitarian Affairs (OCHA) collaborated with forty nations and the

International Federation of Red Cross and Red Crescent Societies to craft a diplomatic initiative fostering effective standards for Urban Search and Rescue operations and efforts to rescue victims from collapsed structures due to any disaster, including terrorist attacks. The U.S. also collaborated with an international committee of experts assembled by the Organization of Economic Cooperation and Development on a study of systemic risks to society that should advance how humanitarian bodies conduct mitigation, early warning and response.

Questions for the Record Submitted to
Secretary of State Colin Powell by
Senator Bunning (#4)
Senate Committee on the Budget
FY04 Foreign Affairs Budget Request
February 11, 2003

Question:

Could you please comment on the new global AIDS initiative and the implementation of the Mexico City Policy with regard to the $10 billion in new money that the President has pledged to fight the global AIDS issue?

Answer:

To be effective, the President's Emergency Plan for AIDS Relief will have to involve coordination among many parties. As we work with Congress to develop this plan and as we implement it, we will ensure that any organization that wishes to participate in the Emergency Plan for AIDS Relief - which will be focused on the prevention, care, and treatment of HIV/AIDS in accordance with the Uganda Model - will be eligible to compete for U.S. funds targeted for that purpose, provided that the assistance is not used to promote or perform abortions.

Question for the Record Submitted to
Secretary of State Colin Powell by
Senator Jim Bunning (#5)
Senate Budget Committee
February 11, 2002

Question:

Could you please address the U.S. Information Agency and how the activities and focus of that agency are changing and adapting to world events - in particular, with regard to the Muslim world and the proposed Middle East television network?

Answer:

In 1999, pursuant to P.L. 105-277, the U.S. Information Agency merged into the Department of State, with activities and initiatives under the direction of the Under Secretary of State for Public Diplomacy and Public Affairs. As with the former U.S. Information Agency, activities are prioritized to adapt to changing world events.

After 9/11, for example, public diplomacy resources shifted to support the war on terrorism worldwide, with a significant emphasis on foreign Arab and Muslim audiences. This resulted in increases of funding by 34% in FY 2002 and 13% in FY 2003 for the South Asian geographic bureau and increases of 15% in FY 2002 and 19% in FY 2003 for the Near Eastern geographic bureau. [FY 2003 figures are drawn from the President's request.]

These bureau increases reflect the priority attention given to the Afghanistan war and the war on terrorism in both these important regions of the world. They also demonstrate the large adjustments that we made immediately following 9/11 and are continuing in FY 2003 to reflect public diplomacy priorities in those regions.

An additional $35 million in supplemental funding for public diplomacy initiatives has also been directed to foreign Arab and Muslim audiences. These activities included broadcasts, speakers, and foreign journalist tours on values and religious tolerance; English language programs, English teaching, and educational reform projects; American studies programs in universities; and programs on Iran and Iraq. They also included exchanges involving youth, women, the Fulbright program, media training, English language instruction, and American studies.

In addition, a number of programs and activities were initiated at Headquarters and provided to field posts in those regions. For example, we have initiated publication of a magazine meant for young Arabic speakers. This pilot project entails four initial print versions, the first due out in April. We have expanded translations of our print and electronic publications into Arabic and other languages, including "Network of Terrorism" and "Muslim Life in America." We initiated a Farsi website and have increased foreign journalist tours and briefings and television co-operative productions with broadcasters from countries with significant Muslim populations. These are just a few of the products reflecting our shift of resources to the Arab and Muslim world.

As for exchanges, in FY 2002 the Bureau of Educational and Cultural Affairs redirected 5% of its base exchange resources ($12 million) to engagement with the Muslim world and the war on terrorism. The FY 2003 exchanges plan maintains this emphasis, increasing the Middle East's share of worldwide exchange resources to 15%, compared to 11% in FY 2002 and 10% in FY 2001. The bureau's Partnerships for Learning exchanges funded by the supplemental funds target specific world regions, focusing 50% on the Middle East, 20% on South Asia, and approximately 10% each on East Asia, Africa, and Eurasia.

The Broadcasting Board of Governors established Radio Sawa last year to reach a wider, younger audience base throughout the region. In the FY 2004 budget, the President requested the establishment of an Arabic-language, Middle East Television network as well. The budget request for this service is $32 million for FY 2004.

Question for the Record submitted to
Secretary of State Colin Powell
Senator Jim Bunning (#6)
Senate Committee on the Budget
February 11, 2003

Question:

I notice that this year's budget request includes $121 million in aid for Indonesia - a decrease of almost 10% from last year's request. Given the political situation in that country, would you please address the activities that the U.S. in engaging in within that country and the uses of U.S. aid?

Answer:

U.S. assistance programs for Indonesia represent flexible and steadily evolving responses to profoundly significant social, economic, religious and political trends. The reductions in aid levels for CSH and DA funding for Indonesia were driven by immediate requirements in Afghanistan and Pakistan. Reflecting our emphasis on counterterrorism, funding levels for support of the Indonesian Government's creation of a new police counterterrorism unit were increased by $4 million.

Our assistance provides support for counterterrorism, democratic transition (including Indonesia's first-ever direct presidential election in 2004), conflict prevention and response, and public diplomacy efforts to present U.S. viewpoints and deepen bilateral understanding. The USG will continue to fund reconciliation and development programs in Aceh, building on the hard won peace process. In the health sector, our programs focus on improving maternal/child health and nutritional status, family planning, preventing the spread of HIV/AIDS, and improving health service delivery. We are providing support to the Government of Indonesia's decentralization of authority to local governments, economic growth, energy sector reforms and natural resource management.

The budget builds on the recently granted authority to restore IMET. The decade-long absence of IMET-trained military officers constrains our interactions with key players in regards to CT cooperation and comprehensive military reform. We are still concerned about the role of the military in a democracy and a general lack of accountability for human rights abuses; hence no FMF authority is requested and we will watch developments carefully to see if other changes to our engagement policy are warranted.

Questions for the Record Submitted to Secretary of State Colin Powell by Sen. Michael B. Enzi (#1) Senate Budget Committee February 11, 2003

UN CAPITAL MASTER PLAN

Question:

Last fall the United Nations General Assembly approved a resolution in support of the Capital Master Plan for renovation of the UN Secretariat building. The building is in dire need of repair for both the health and safety of the employees and diplomats who work there. There is no funding for the Capital Master Plan in the President's budget. The fiscal year 2003 estimate includes $1 million for a CMP task force and around $8 million for CMP assessment.

What is the Administration's position on the Capital Master Plan and what is the status of discussions for funding of the renovation?
Are there plans to begin discussions with Congress on the level of funding and how that funding will be appropriated?

Answer:

The Administration supports the concept of the Capital Master Plan (CMP) for renovation of the UN headquarters complex in New York. The complex is aging, does not meet current building codes for fire and safety, is not energy efficient, and is in need of significant security upgrades.

No decision has been made with regard to the funding of the renovation. Once the Administration has reached a decision on the funding issue, it will hold consultations with the Congress.

Questions for the Record Submitted to Secretary of State Colin Powell by Sen. Michael B. Enzi (#2) Senate Budget Committee February 11, 2003

SYNCHRONIZATION OF U.S. DUES TO THE UNITED NATIONS

Question:

What plans are being discussed to re-synchronize the US payment of dues to the United Nations? Does the President's budget request contain funding to begin the process of synchronization?

Follow-up: How do you propose to rectify the issue of the U.S. paying late?

Answer:

Our FY'04 request contains no funding for synchronization. The State Department has considered options to move off the practice of making deferred payments to the United Nations and other major organizations. It would be helpful to the UN and other major international organizations if funds could be provided early in their January-to-December fiscal year, so that it is no longer necessary for them to borrow from other internal accounts to cover the part of their assessments that come from the United States. Deferral is a practice that engenders some frustration from these organizations and the other Members States without appreciably adding to U.S. leverage to influence the course of their financial and management practices.

However, we estimate that such synchronization would require some $700 million in one-time additional funding. As a way to lessen the funding burden, we have examined plans to resynchronize payments on an incremental basis. However, even spread over four or five years, the level of additional annual funding would be quite significant. We continue to look into this issue, but given competing demands for resources, there is no assurance that funding for this purpose can be accommodated in upcoming budget requests.

**Questions for the Record Submitted to
Secretary of State Colin Powell by
Sen. Michael B. Enzi (#3)
Senate Budget Committee
February 11, 2003**

U.S. EMPLOYEES AT THE UNITED NATIONS

Question:

Has any progress been made in increasing the number of US citizens employed by UN agencies and organizations overseas? What efforts are being made in New York to ensure that an appropriate number of Americans are employed in the UN management levels?

Answer:

The Department is continuing its efforts to attain equitable representation of Americans in UN agencies and other international organizations (IOs). We have instructed our Missions to encourage more actively IOs under their purview to appoint Americans. To enhance our Missions' efforts, over the past two years we sent a recruitment expert from Washington to urge agencies in Rome and Geneva to increase their employment of Americans. In addition, we are taking steps to work more closely with other U.S. Government agencies to leverage their resources to better identify and promote potential candidates for IO employment.

In New York, we are intensifying our efforts to get more Americans employed at the UN Secretariat, including at management levels. These efforts include more frequently raising this matter with UN officials, engaging with potential American candidates, and highlighting publicly the need for the UN to ensure that member states are equitably represented.

We expect that these and other efforts underway will result in increased American employment in international organizations.

We are aware of the interest of the Committee and will continue to confer with the Congress regularly on this matter.

Questions for the Record Submitted to
Secretary Colin Powell by
Senator Enzi (#4)
Senate Budget Committee
February 11, 2003

VISAS

Background: Two recent reports from the Government Accounting Office and the State Department's Inspector General highlighted problems with the visa issuance process within the Consular Affairs bureau (e.g., staffing inadequacies, lack of language and other training for consular officers, limited intelligence sharing, lack of access to new technology, etc.) These problems are not only affecting our ability to clearly identify and promptly address applications from those who may wish to do us harm, but they are also hurting the economic stability of the U.S. In an age of global business, American companies have forged valuable relationships with both foreign customers and suppliers. Further these U.S. companies rely on personal interaction to conduct business and share certain knowledge with these foreign engineers, academics and businessmen.

Question:

1) It is my understanding that the State Department is working to decrease the waiting period for the issuance of non-immigrant visas for foreign scientists to 15 days. Can you share with the committee how your budget request addresses the needs outlined by GAO and the OIG for the Consular Affairs bureau?

2) Can you describe the changes that have been made in the consular area since September 11, 2001, that are intended to heighten the caution with which we grant entry to the United States?

Follow-up: Could you describe the relationship between the Department of Homeland Security and the Department of State in issuing visas when the Department of Homeland Security will be making the policy decisions and your department will be issuing the visas?

Answer:

Question 1):

The Department's FY 2004 budget includes $616.821 million to fund the Border Security Program. This program funds virtually all consular operations worldwide. The program addresses many of the issues raised in the reports from the General Accounting Office and the State Department's Inspector General. For example, consular staffing needs are addressed through the funding of the salaries of approximately 2,400 full time domestic and overseas consular personnel and support staff. The program provides all consular staff with modernized consular systems. Hardware and software is replaced on a routine basis, while systems training of new consular hires and refresher training for existing personnel follows an 18 month training schedule. The Consular Lookout and Support System (CLASS), which is a database of over 15 million names, allows consular officers immediate access to information needed for visa and passport adjudication. This information is also shared with other government agencies involved in homeland security. The Border Security program also provides specialized consular training on all aspects of consular work through the Department' Foreign Service Institute.

Question for the Record Submitted to
Secretary of State Colin Powell by
Sen. Enzi (#4.2)
Senate Budget Committee
February 11, 2003

Question: Can you describe the changes that have been made in the consular area since September 11, 2001, that are intended to heighten the caution with which we grant entry to the United States?

Answer:
I testified last July before the House of Representatives on the Homeland Security bill, stating that "...our first line of defense in protecting ourselves from those who would come to our shores are our diplomats at our consulates and other locations around the world, where we issue visas to people to come to America." The Department has no greater responsibility than that of securing our nation's borders through vigilance in the visa function and there is no area to which we have devoted greater attention, thought, and resources. The Department of State has made sweeping changes to the visa and passport processes and entry screening requirements during the months since September 11, 2001. The steps outlined below are just some of our efforts to improve the security of U.S. borders, which also include our ongoing participation in interagency efforts to implement the provisions of the USA Patriot Act and Enhanced Border Security Act, the National Security Entry Exit Registration System (NSEERS),

and the formation of the new Department of Homeland Security.

Improvements Made in Visa and Passport Processing

Document integrity

- In March, 2002, pilot tested the new, tamper-resistant Lincoln visa with worldwide deployment to be completed by May, 2003.
- Converted all domestic passport agencies to issue the new, more secure photo-digitized and tamper-resistant US passport.
- Shifted production of all "non-emergency" overseas passports from posts abroad to the US to take advantage of photo-digitization technology. Began testing electronic transfer of passport data between posts and a domestic passport center. This new process will eliminate the need to send paper applications to a domestic passport center for passport book production. The pilot is progressing satisfactorily. We expect to implement this new process at all posts by the end of 2003.
- Implemented the Passport Lookout Tracking System (PLOTS), containing roughly 150,000 fraud files, which can be

reviewed system-wide to prevent issuance of fraudulent U.S. passports.

- Developed and deployed a unique, secure ink for canceling machine-readable visas to deter "visa washing," the practice of treating an issued visa with chemical solvents in order to removed the toner and thus use the visa foil for fraudulent purposes. The new ink fully permeates the visa to prevent fraudulent use.
- Deployed the Consular Lost and Stolen Passport (CLASP) lookout system to all overseas posts, serving as the central repository for information regarding lost or stolen U.S. passports. Data entered into CLASP is also automatically forwarded to the U.S. Customs Service's Treasury Enforcement Communication System (TECS) to assist in the apprehension of imposters using lost and stolen passports at the ports of entry.
- Created a network connection for electronic access to digital images of passport records to all passport agencies, consular posts, and authorized CA Headquarters personnel. The information contained in the system is used to provide information needed for verifying passport issuance in cases of lost/stolen passport replacement,

avoiding questionable passport issuance and verifying citizenship verification.

Application Processing

- Increased percentage of applicants interviewed worldwide.
- Added more security checks for certain groups of visa applicants from certain countries.
- Provided access to the Consular Consolidated Database (CCD) for all consular officers worldwide as well as to INS inspectors at port of entry, US Customs personnel and other entities.
- Expanded intranet resources for consular adjudicators and Diplomatic Security investigators to assist them in reading and verifying entry/exit cachets in Arabic or Persian script.

Namechecks

- Incorporated approximately 8 million records from the FBI's National Crime Information Center (NCIC) into our Consular Lookout and Support System (CLASS) namecheck database. This more than doubles the records on file.
- Received into CLASS a significant increase in namecheck records from the intelligence community (through TIPOFF -

the State Department's clearinghouse for sensitive intelligence and watch-list entries). (TIPOFF has processed approximately 31,000 new entries since October 2001 bringing the total to over 78,000 terrorist lookouts).

- Started automated cross checking of new derogatory information concerning terrorists or suspected terrorists (including TIPOFF entries) against CCD records of previously issued visas. When there is a match, the visa is revoked and DHS notified.

- Placed the US Marshals database (WIN) of 20,000 individuals not entitled to passports because they are subject to outstanding federal warrants of arrest into the passport side of CLASS in November 2002.

- In January 2003, began pilot test in Mexico of the new Hispanic algorithm which we believe will greatly increase the accuracy of namecheck returns for Hispanic names.

- Completed East Asian algorithm linguistic study as the first step in the process of developing language- and culture-specific algorithms to better support namechecks in CLASS for East Asian names.

- Prepared Backup Namecheck System (BNC) using Real-Time Update (RTU) for deployment beginning early 2003. This is a backup namecheck system designed to support visa operations in the increasingly rare event of telecommunications failures. With the combination of BNC and RTU, the CLASS visa database is replicated on a near-realtime basis to PC-based backup systems at each consular post worldwide.

- Upgraded the Travel Document Issuance System - Photodig (TDIS-PD) to include the Consular Lost and Stolen Passport (CLASP) database and a new Social Security matrix. The CLASP database includes all reported lost and stolen U.S. passports, while the Social Security matrix determines the State and issuance date for a social security number which is then compared to the State and date of birth provided by an applicant, helping passport personnel to flag questionable cases for further analysis.

Enhanced Data Collection

- Included 25 additional data elements in the automated NIV processing system (NIV 4.01) to be in worldwide use in early 2003. Most of these data elements were added at the request of the law enforcement and intelligence communities and will greatly enhance our ability to share meaningful case information electronically.

- Created new forms -- the DS-157 (November 2001) and DS-158 (July, 2002) -- to expand data requested of targeted cases and revised DS-156 to expand data collection, again to increase the amount of information available to the larger border security community.
- Provided all posts with software and scanners to support scanning of supporting evidence for serious refusals. By adding images of these documents to the consular database, refusal details will be more widely available to inspectors at ports of entry and others in the border security community.
- Electronically capture photos for all refused NIV applicants, expanding the database of photos as a resource for anti-fraud and border security work.
- Revised photo standards for NIV applicants to improve quality of data for facial recognition and other purposes. As these higher quality photos are added to the consular database for every visa applicant (whether issued or refused), the USG steadily gains photos for identification to aid with visa adjudication and national security tasks.

Expanded Information Sharing

- Expanded Consolidated Consular Database (CCD) access to all US ports of entry and other US government agencies.
- Piloted data-share with the Social Security Administration to facilitate the issuance of Social Security number cards to new legal immigrants.
- Serious visa refusal files for posts in high intelligence threat regions or those with space problems are stored at the Kentucky Consular Center (KCC). These are refusals dealing with "Category 1" grounds of ineligibility, having to do with terrorism, criminal, national security and other serious grounds of visa refusal under US law. KCC has begun back-scanning, in order to make these files available to all users of the Consular Consolidated Database (CCD).
- Expanded distribution of the Department of State's electronic Intelligence Alerts on lost/stolen blank documents, making them available to more than 700 addresses in federal, state, and local agencies and to foreign governments.
- Began automatically forwarding data from the Consular Lost and Stolen Passport (CLASP) system to the U.S.

Customs Service's Treasury Enforcement Communication System (TECS) for use at ports of entry.

- Began back-scanning previously issued US passport applications which will make the data available back to 1994. Approximately 8 million records have been scanned. Once this project is completed, passport records including photographs will be available for all currently valid passports.

Internal Controls

- Restricted Foreign Service National (FSN) employee access to namechecks.
  - Removed FSN ability to request namechecks outside of an actual visa application. This change was made worldwide through the deployment of a new tool for use in conducting ad hoc namecheck queries by American personnel only.
  - As a pilot, removed FSN access to all namecheck information in the NIV system at six pilot posts in August, 2002
  - Worldwide restrictions to begin in March 2003.
- Announced changes to the role of Consular Associates, cleared American citizens used in consular work overseas.

This involves a fundamental realignment of American consular resources overseas so that visa adjudication is restricted to commissioned Foreign Service officers while other sensitive consular activities are given to cleared American personnel in lieu of Foreign Service Nationals.

- Visa Referral system reviewed and post/consular managers reminded of controls needed. Form revised and made mandatory.
- New management tools to monitor user accounts on consular automated systems.
- Mandated a special worldwide review of management controls.
- Implemented Consular Management Assistance Teams, which visit posts to review management controls and procedures, and expanded the management assessment review program at passport agencies.
- Began the process of formalizing and disseminating Standard Operating Procedures for visa processing.
- Are establishing with Diplomatic Security a vulnerability assessment unit within CA to examine fraud trends and identify issues for further investigation.

Fraud Prevention Efforts

- Establishing anti-fraud units at the National Visa Center in Portsmouth, New Hampshire (NVC) and the Kentucky Consular Center (KCC). First goal is data validation/fraud screening for employment-based cases using automated search tools to query a wide variety of commercial and government databases concerning company backgrounds. Recruitment of Fraud Program Manager position for NVC is underway. After experience gained program will be expanded to KCC.
- Based on success in identifying imposters and duplicate entries with the Diversity Visa lottery (DV) program, anti-fraud efforts using Facial Recognition are being expanded to 13 other NIV applicant pools on a pilot basis. These countries were chosen due to a combination of security and fraud management concerns.
- Commenced pilot program with Virginia DMV to share information on fraudulent foreign documents submitted in support of drivers license applications.
- Implemented program with SSA to train SSA investigators on the detection fraudulent foreign documents, and to increase information sharing between SSA investigators and passport agencies.

- Initiated work with a contract consultant to design approaches for mining data in the Consular Consolidated Database to provide additional anti-fraud and management oversight information.

Guidance/Training

- As part of the effort noted above to prepare and disseminate standard operating procedures for consular work, working to revise all training materials to incorporate this guidance.
- Initiated an Advanced Namechecking course at the Foreign Service Institute.
- Made changes to the basic consular training course to add additional material on fraud, ethics and terrorism in addition to new material on interviewing techniques.

Security Improvements

- Participated in the drafting of an Entry-Exit Project Charter (National Security Entry Exit Registration System, NSEERS), working jointly with INS, Customs, and DOT, which sets the parameters for an automated system to record the arrivals, departures, and stay activities of individuals coming to and leaving the U.S.

- Have proposed the elimination of crew list visas (proposed regulation has been published for public comment). This is important because travelers on crew list visas do not require individual passports and visas, so the elimination of this visa class will provide for more thoroughly documented and reviewed travelers.
- Are now requiring visas for landed immigrants (from non-Visa Waiver Program countries) in Canada and Bermuda. This change was made in order to ensure that all travelers to the US are subject to appropriate levels of scrutiny in the visa process independent of their current country of residence.
- Have amended regulations to prevent automatic revalidation of visas for NIV applicants with expired visas and a valid I-94 who apply in Canada or Mexico and for all nationals of "state sponsors of terrorism" regardless of whether they apply for a visa.
- Have reiterated standing guidance on interview requirements for applicants subject to security advisory opinion requirements.
- Are working closely with DHS field and service center operations to support their increased use of DOS lookout

data available in the Interagency Border Inspection System (IBIS) for benefits processing.

Follow up

Question: Could you describe the relationship between the Department of Homeland Security and the Department of State in issuing visas when the Department of Homeland Security will be making the policy decisions and your department will be issuing the visas?

Answer:

The Department of State has begun discussions with the new Department of Homeland Security concerning the details of the Memorandum of Understanding that will address many of the issues related to policy coordination and visa operations. These discussions are ongoing and at this point it would be premature to attempt to describe specific working arrangements. However, the Department of State looks forward to a close and cooperative relationship with the Department of Homeland Security as we work to process visas and implement other border security initiatives in ways that improve the national security of the United States while aiding, to the extent possible, legitimate international travel and commerce.

Question for the Record submitted to
Secretary of State Colin Powell by
Senator Enzi (#5)
Senate Budget Committee
February 11, 2003

DIPLOMATIC READINESS:

Background: One of Secretary Powell's top priorities in the State Department budget is funding for more people. When he first launched a "Diplomatic Readiness Initiative" to add some 1,000 staff above attrition who would represent "the rich diversity that is America." In 2002, 360 new employees were added above attrition. The number of foreign service generalists today is only 4880 today compared to 4630 in 1986, some 17 years ago. (These numbers discount the USIA employees who joined the State Department ranks when the agency was merged into the Department.)

A) There have been several reports about significant staffing shortfalls in many hardship locations such as China, Saudi Arabia, and Ukraine. There has also been concern raised about junior officers filling positions where they do not have either the appropriate experience or the necessary language skills. **Is the Diplomatic Readiness Initiative addressing these problems?**

B) Last year's State Department authorization included a provision on virtual locality pay for the calculation of retirement pay for foreign service employees. **In what other areas would you recommend Congress assist in the Diplomatic Readiness Initiative by improving the recruitment and retention for foreign service employees?**

Answer:

A) The Diplomatic Readiness Initiative (DRI) is now in its second year, while the staffing shortages - especially at the mid-level - took a decade to create. During the 1990s while international commitments were increasing, foreign affairs becoming more complex and challenging, and new embassies opening, we were not even hiring enough people to replace those who left the Department.

The DRI was designed to meet critical overseas requirements that were not being met under low staffing levels, to provide enough people to allow us to respond to crises and emerging priorities and provide more needed training without neglecting day-to-day responsibilities.

As a result of the first year of the DRI, we have hired double the number of Foreign Service officers as we did in FY2001 and have increased training in consular work and hard languages for Junior Officers. We have placed most of our new hires overseas, beginning to meet those critical staffing needs. As we continue with the DRI, we will be filling more and more overseas positions, reducing the strain on hardship posts that had been understaffed.

However, this increased hiring will not begin to affect mid-level staffing for 5-10 years. Due to the under-hiring of the 1990s, we are still suffering with a mid-level staffing gap. As a result, we have asked talented Junior Officers to fill some positions overseas that are traditionally above their level. In those situations we strive to reorganize responsibilities in the section to ensure that they are not asked to perform supervisory or other duties that would be inappropriate. Because we hire at the entry level, this kind of approach to meeting staffing needs will persist for several years until we have filled out the ranks.

In addition to the increased hiring we have implemented stronger procedures to ensure that the burden of hardship service is more evenly spread. We are currently studying recommendations from a set of working groups established by the Under Secretary for Management that looked at both incentives for hardship service as well as ways to make that particular service less hard. Ultimately, the only way to ensure posts are properly staffed is to have higher overall employment so all requirements can be met.
As we finalize work on our hardship working group recommendations, we may find a need for funding or legislation in order to provide for greater incentives for service in difficult posts or for improving conditions in those locations.

B) Most importantly, we need continuing support for the Diplomatic Readiness Initiative so that we can implement we've already implemented our training plans and have people in appropriate numbers for our missions? Without adequate staffing to support training, we will not be able to improve management within the Department, a key concern for our employees.

DEPARTMENT OF TRANSPORTATION'S FISCAL YEAR 2004 BUDGET PROPOSALS

THURSDAY, FEBRUARY 13, 2003

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

The committee met, pursuant to notice, at 2:34 p.m., in room SD–608, Dirksen Senate Office Building, Hon. Don Nickles (chairman of the committee) presiding.

Present: Senators Nickles, Allard, Burns, Cornyn, Conrad, Sarbanes, Murray, Wyden, Byrd, and Corzine.

Staff present: Hazen Marshall, staff director; and Don Kent, senior analyst.

For the minority: Mary Ann Naylor, staff director; and Sarah Kuehl, analyst.

OPENING STATEMENT OF CHAIRMAN DON NICKLES

Chairman NICKLES. The committee will come to order.

Today we will hear testimony from Michael Jackson, who is U.S. Deputy Secretary of Transportation. Mr. Jackson, we welcome you to this committee.

Mr. Jackson serves as the Department's chief operating officer with responsibility for day-to-day operations of 11 modal administrations and works with over 100,000 DOT employees nationwide. Prior to coming to this position, he served as chief of staff of the Secretary of Transportation during President George H.W. Bush's administration, and prior to that served in the private sector both with Lockheed Martin, IMS Transportation Systems and Services, and also worked as president of the American Trucking Association.

Mr. Jackson, we welcome you. Before I call upon you for your opening remarks, I will ask my colleague, Senator Conrad, if he has any opening remarks he wishes to make.

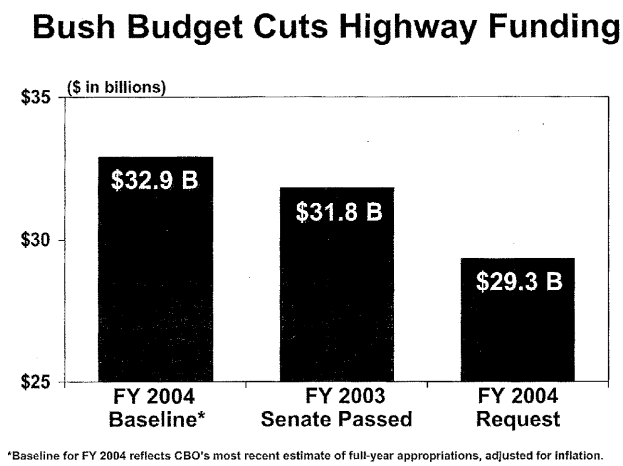
OPENING STATEMENT SENATOR CONRAD

Senator CONRAD. Thank you, Mr. Chairman. Thank you for holding this hearing. Thank you, Mr. Jackson, for being here today. We appreciate your appearance.

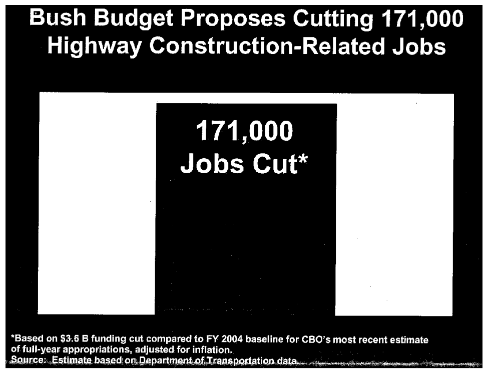
Let me talk about what we see in this budget proposal and things that concern us, if I can, and then perhaps you could address some of these matters in your testimony, or perhaps we can do it when we get to questions. But let me just start with a quote from the Director of OMB before this committee earlier this month, in which he said, "A better infrastructure is very good for the economy. When I think of highways, I think first of all of the ways they enable businesses and individuals to practice more commerce. We need a good infrastructure to do that.”

I personally strongly agree with the opinions expressed by the Director of the Office of Management and Budget. But when I look at the President’s budget, I see something that doesn’t match the words. The President has put forth a transportation spending plan that will force States to cancel or postpone hundreds of road, bridge, and transit projects at a time when they are facing their own fiscal crises. States such as Texas and Virginia have already served notice that they will be canceling hundreds of millions of dollars in highway projects in the wake of large State deficits. I am very fearful that the plan put forward by the Administration will only make that circumstance worse.

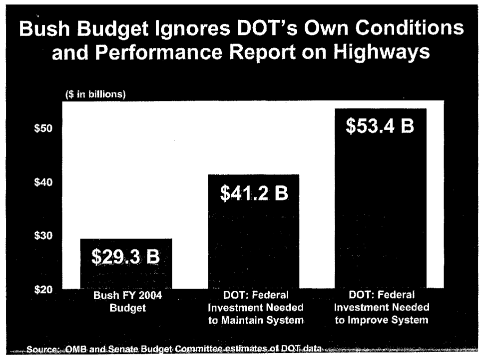
Let's go to the next chart. The President has proposed reductions, almost 11 percent below the 2002 level, and 6.7 percent below the level expected to be enacted for 2003. We can see the baseline for 2004 would be $32.9 billion. What passed for 2003 was $31.8 billion. That is the Senate-passed version. For 2004, the President is proposing $29.3 billion.



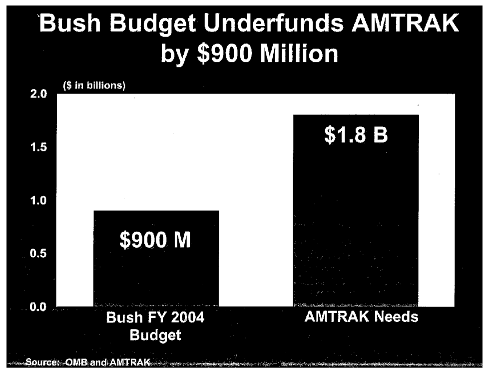
That is a proposal—let's go to the next chart—that we are told will cut jobs by 171,000, that at the time the President is proposing a growth package to increase employment, increase economic activity, and yet, on the other hand, is proposing a budget for transportation that will reduce the number of jobs by almost as much as what he is talking about increasing the number of jobs. This to me does not make sense.



Let's go to the next chart. Your own Department issued its conditions and performance report last week. For the highway program alone, adjusted for inflation, the report says that we need an average annual Federal investment of $41.2 billion to maintain the existing interstate highway system. To actually improve the system, we would need an average annual Federal investment of nearly $53.4 billion. Yet the Administration has come forward with a proposed highway funding level that starts at $29.3 billion and only reaches $33.9 billion by the end of fiscal year 2009. I really question whether this is a credible budget proposal.



Now, Mr. Jackson, I could go down a list of other cuts in the transportation budget proposal, but I think the other one I would like to focus on is Amtrak, cutting Amtrak funding by 14.2 percent below what is now expected to be in the 2003 omnibus bill that we will act on perhaps as early as tomorrow. Hopefully we will.



The President has proposed $900 million in Amtrak funding, nearly $900 million less than what Amtrak is expected to ask for in order to maintain its existing system and to avoid further delay in critical capital improvements in fiscal year 2004.

Finally, I am also concerned about your proposals to require communities to contribute large subsidies to participate in the essential air service program. I can tell you, in terms of growth, economic development, the single most important thing that companies talk to me about when they are talking about operations in North Dakota, bringing operations to North Dakota, is: What is your air service? This move on essential air service threatens that vital lifeline.

So these are areas of concern that I hope you will address in your testimony or, again, perhaps in questions that we get to afterwards. Again, thank you for being here.

Chairman NICKLES. Senator Conrad, thank you very much.

Secretary Jackson, just a couple of comments. Correct me if I am wrong, but in 1998, in highway funds we were spending about $200 billion. In the year 2000, when we had a big increase in highway funds, it went up to $27 billion. The year just completed, in 2002, it was $32 billion, so that went up by 60 percent between 1998 and 2002. Correct me if I am wrong, but that is a tremendous increase, funded primarily by gasoline taxes. So I just want to kind of put this in relative—some people say, well, wait a minute, that might be less than what we just appropriated—we haven't finished, but the appropriation bill we will finish tonight or tomorrow. Like I say, it has been on a very steep climb if you increase spending for highways between 1998 and 2002 of 60 percent. That is a pretty significant increase. I just wanted to point that out.

Secretary Jackson, we welcome your testimony today. We have a lot of big challenges, certainly in highways, mass transit, essential air service. You have some proposals. We look forward to hearing you explain some of those. So welcome to the Committee.

STATEMENT OF MICHAEL P. JACKSON, DEPUTY SECRETARY OF TRANSPORTATION, UNITED STATES DEPARTMENT OF TRANSPORTATION

Mr. JACKSON. Thank you, Chairman Nickles. I appreciate it. Members, I appreciate the ooportunity to be here today.

Secretary Mineta is unable to be here but sends his warm wishes. He is recovering from back surgery but is doing terrifically well and expects to be back in the office soon.

Chairman NICKLES. Please give him our regards as well. He is a friend of all of ours on the Committee.

Mr. JACKSON. Yes, sir, I certainly will do that.

On his behalf then, I am pleased to present to you an overview of the Department of Transportation's 2004 budget. As you know, President Bush is requesting a $54.3 billion budget for the Department, a 6-percent increase. Also, as you know, two modes of the Department of Transportation—the Transportation Security Administration and the U.S. Coast Guard—will be departing the Department on March 1st to go to the new Department of Homeland Security. We celebrate their many successes with us, and we look forward to working with them as we go forward in this new departmental arrangement.

I would like to discuss the highlights from the DOT 2004 budget and just point to a few key initiatives, and then perhaps we can answer some of the questions raised, Mr. Chairman, by you and Senator Conrad.

As you know, the current laws authorizing surface and aviation transportation are up for reauthorization this year, and we will be spending a significant amount of our energy working with the Congress working on these reauthorizations during the course of the year. We will release before too long the details of our aviation and surface transportation reauthorizations, but I want to share just a couple of the principles that will be animating our work.

For the surface transportation programs, we will include increased funding flexibility for States and local authorities. We will continue to encourage innovative financing tools, and DOT will seek to improve efficiency for freight transportation networks and to support the more efficient movement of freight transportation. We will support efficient environmental review processes and make them a priority. We will continue a strong emphasis on public transportation by simplifying transit programs and fostering a seamless transportation network. Finally, our proposals will include an emphasis on consolidating and expanding Federal safety programs.

I would like to repeat myself on that point. For DOT, 2003 will be a year of special focus on highway and aviation safety. Secretary Mineta has challenged the Department to take the same type of innovation and focus and discipline that we used to stand up the Transportation Security Administration during this past year and focus that same passion on addressing the safety issues that confront the Department. There are forty-two thousand deaths a year on our highways. Almost one out of four, or over 9,000 of these lives, could be saved if people would just buckle up. We have to do better in this. We will do better in this. The President's proposals include some concentration reducing highway fatalities by focusing on seat belt usage, impaired driving, and other safety initiatives.

Regarding the highway reauthorization budget, let me begin with the fundamental principle. We are committed to maintaining the guaranteed funding levels that link highway funding to Highway Trust Fund receipts. We are committed to the firewalls.

In fact, the President's budget request will actually propose to obligate more for highway programs than we expect to collect in the Highway Trust Fund. We will squeeze everything we can out of the Highway Trust Fund. We will preserve the principle of the firewalls. We will actually partially spend down the trust fund balance, and we will try to squeeze as much value out of the trust fund as we can. But the President's budget does not propose to increase highway user fees.

For the Federal Highway Administration, the Administration's 2004 budget request proposes that all revenue from gasohol taxes be deposited directly into the Highway Trust Fund rather than the General Fund, as it is currently structured. That is a $600 million a year boost in Highway Trust Fund obligations, and it goes throughout the course of the reauthorization.

In addition to making obligations above the level of estimated receipts into the Highway Trust Fund, we unveil a brand new $1 billion infrastructure performance and maintenance initiative specifically aimed at addressing immediate highway needs with projects that can be implemented quickly—getting money out to States and localities to make essential repairs and to do work quickly. We hope this will improve operating efficiency and remove bottlenecks and put people to work in the transportation industry.

All up, our proposed program spends at a level that keeps the Highway Trust Fund balance relatively constant. The obligation limit for 2004 is $29.3 billion. This is a 6-percent increase above the President's amended request for 2003.

I would be happy to talk in greater detail in the Q and A session, Mr. Chairman, about the annual movements and the levels of investment in the trust fund, and I suspect that your questions will point us in that direction.

When comparing the President's 6-year surface transportation reauthorization proposal in total—including highways, highway safety, transit, and motor carrier safety—to the 6 years of TEA–21, the President proposes an overall increase of 19 percent.

Reducing highway fatalities is priority one for the National Highway Traffic Safety Administration, and the President's budget requests $665 million for NHTSA to reduce fatalities, prevent injuries, and encourage safe driving practices; $447 million of NHTSA's

2004 funding request will support grants to States to enforce safety belt and child safety seat use, and to reduce impaired driving.

At DOT we are also working to keep our highways safe through the work of the Federal Motor Carrier Safety Administration by focusing on ways to prevent fatalities and injuries resulting from accidents involving commercial motor carriers. The 2004 budget request includes $447 million to address these problems.

Another way to improve transportation safety is to continue to encourage the use of public transit, a dependably safe and efficient way to get people where they need to go. The President's 2004 budget request includes $7.2 billion to strengthen and maintain our public transportation networks. It includes $1.5 billion to fund 26 new start projects that will carry 190 million riders annually when completed.

Having touched briefly on these surface issues, I would like to turn to the reauthorization of our aviation program. While we will soon release policy details of our aviation reauthorization proposal, let me say the President is requesting $14 billion for FAA programs.

Because travel demand in air services will inevitably return to pre-9/11 levels, and because we will face once again capacity problems and constraints in our aviation system, it is important to continue our Federal investment in this area. It is also important to continue to remain focused on aviation safety issues to meet our goal of reducing aviation fatality rates by 80 percent over the period from 1996 to 2007.

To meet both safety and mobility needs, the budget proposes to spend a greater portion of the accumulated cash balances in the Airport and Airway Trust Fund. Again, we propose to spend down the trust fund. In the post-9/11 environment, receipts into the trust fund have dropped. We are proposing to work hard to use the money that we have available in the trust fund and extend it as far as possible.

The President's budget request and our reauthorization proposals maintain current levels of aviation infrastructure investment and expand FAA's safety staff, including the number of air traffic controllers needed to man our air traffic control system in the future as we face an anticipated cycle of retirements in the next several years.

Let's turn now to railroads, a topic that has already been raised. First, Amtrak. Amtrak faces severe and persistent financial challenges. The Administration has asked Congress to adopt reforms that will strengthen Amtrak's business operations and its financial condition, but Amtrak continues to request funds, indeed request more funds, to maintain the same mode of operation that has existed for the last 30 years. The Federal Government simply cannot afford business as usual at Amtrak.

The 2004 budget request includes $900 million for Amtrak. This is a funding level with a message. We need to do better at Amtrak. We need to make core business improvements.

Passenger rail, I would like to say, is an important part of the overall transportation infrastructure. We need viable passenger rail, and we look forward to working with Congress on an economically viable reauthorization proposal.

Finally, I want to share with you the President's request for our maritime programs. The Maritime Administration supports essential transportation and intermodal connections for domestic and international trade, and the President has requested $219 million for MARAD. One of MARAD's continuing challenges is the disposal of obsolete ships, those that pose a potential environmental risk to our Nation's waterways. The 2004 budget request includes $11.4 million for removal of the highest risk vessels.

My prepared remarks focus on these and many other parts of the Department's transportation objectives. I would like to thank you again for the opportunity, Mr. Chairman, to speak today with the Committee. I look forward to responding to any questions that you may have, and I would ask that my prepared remarks be considered part of the record.

[The prepared statement of Michael Jackson follows:]

STATEMENT OF

THE HONORABLE MICHAEL P. JACKSON

DEPUTY SECRETARY OF TRANSPORTATION

Before the

COMMITTEE ON THE BUDGET

UNITED STATES SENATE

Washington, D.C.
February 13, 2003

Mr. Chairman, Members of the Committee, thank you for the opportunity to appear before you today to discuss the President's fiscal year (FY) 2004 budget request for the Department of Transportation (DOT).

At the onset let me say that Secretary Norman Mineta sends his regrets, as he is unable to be here today. As many of you know, he is recovering from back surgery. While he recovers, we are in constant communication and he sends his regards. He is feeling great, is in high spirits and is ready to be back at work in the near future.

President Bush is requesting $54.3 billion for DOT – a 6 percent increase over the 2003 President's request –including over $14 billion, or 27 percent, targeted towards supporting Secretary Mineta's top priority – safety.

2004 presents tough choices. The President must balance pressing domestic needs, meet our international responsibilities and protect against terrorist attacks at home. As the President made clear in his State-of-the-Union address, the Federal budget reflects a growth at a rate of about 4 percent. In this context, our proposed funding for DOT at a 6 percent growth is responsible, and will support important transportation needs.

During the past year, we at DOT have worked to strengthen our important role as guardians of the nation's transportation systems. Under the leadership of Secretary Mineta, the DOT Team is hard at work to ensure a safe and efficient Federal transportation system for all Americans.

This budget request provides the foundation for a new reauthorization cycle in both surface and aviation programs that will guide the course for these important programs for the next several years.

The President's budget request also reflects the first full year of funding for the newly established Department of Homeland Security. Two major DOT operating administrations – the United States Coast Guard and the Transportation Security Administration – are moving from DOT to the new Department of Homeland Security.

DOT is proud to have provided guidance and support to the United States Coast Guard for more than 35 years. Whether saving the lives of those in distress at sea, protecting the nation from the scourge of illegal narcotics, or responding to environmental catastrophes like the Exxon Valdez oil spill – we at DOT celebrate the

Coast Guard's many accomplishments and we wish them "Godspeed" as they take on an expanded role in homeland security.

We are also honored to have shepherded the Transportation Security Administration – TSA – from its birth through its first full year of operation. TSA has overcome enormous challenges to bring discipline and consistency in providing security to the traveling public. The Secretary and his entire team are extremely proud that TSA has successfully met its deadlines for bringing airports throughout the country into compliance with new security procedures.

Although TSA has much work ahead – particularly to address non-aviation security issues -- we are confident that this new organization is off to a good start and headed in the right direction.

We look forward to continuing to work closely with the Coast Guard, TSA and the Department of Homeland Security to ensure that the nation has an efficient, safe, and secure transportation system.

Now, I would like to emphasize some of the highlights in the DOT 2004 budget request and key initiatives in the President's proposal.

Current laws authorizing both surface and air transportation programs will expire at the end of 2003. In anticipation of this, the 2004 budget request includes the budgetary foundation for proposed new legislation that will authorize these programs for the next several years.

A few details of the Administration's reauthorization proposals are still being refined; however, I want to share with you now several principles that will animate our surface and aviation transportation proposals.

- For the surface transportation programs, we will include increased funding flexibility for State and local authorities to make effective program investments.

- We will continue to encourage innovative financing tools to extend the reach of our transportation investments.

- Efficient environmental review processes will be a priority, and we will continue to implement the President's streamlining Executive Order.

- DOT will seek to improve efficiency for freight transportation networks – a crucial driver of our nation's economy.

- We will continue a strong emphasis on public transportation by simplifying transit programs and fostering a seamless transportation network.

- Finally, our proposals will include an emphasis on consolidating <u>and</u> expanding Federal safety programs.

I want to repeat that last point: for DOT, 2003 will be a year of special focus on highway and aviation safety. For the last 15 months, Secretary Mineta and his senior management team have spent a great deal of time focused on the security threats that face transportation. This was absolutely necessary. We've made great progress.

But for this year, and going forward, Secretary Mineta has challenged us to focus that same passion and innovation on a simple but profoundly important goal: improving safety, saving lives.

Forty-two thousand people perish annually in traffic accidents. Almost one out of four – over 9,000 lives -- could be saved, if America would only buckle up. We *can* do significantly better; we *must* try. And the President's budget request will make a meaningful investment to strengthen our partnership with states and the public to improve safety.

We look forward to unveiling the details of our reauthorization legislation very soon, and to working with the Congress on swift passage.

Regarding the highway reauthorization budget, let me begin with a fundamental principle: we are committed to maintaining the guaranteed funding that links highway spending to Highway Trust Fund receipts.

In fact, the President's budget request will propose starting the reauthorization by actually obligating more for highway programs than we expect to collect in Trust Fund receipts. We will squeeze everything we prudently can from the Trust Fund, but the President's budget request does not propose new user fees.

For the Federal Highway Administration, the Administration's 2004 budget request proposes that all revenue from gasohol taxes be deposited directly in the Highway Trust Fund, rather than the current approach that deposits gasohol taxes to the General Fund. If enacted, this one change will add more than $600 million of available funding to the Highway Trust Fund for each year of the authorization cycle.

In addition to spending estimated Highway Trust Fund receipts, our proposal also unveils a brand new $1 billion Infrastructure Performance and Maintenance initiative specifically aimed at addressing immediate highway needs and at projects that can be implemented quickly. Totaling $6 billion over the authorization period, this funding will target projects that address traffic congestion and bottlenecks, and improve pavement conditions.

All up, what our proposed program does is spend at a level that keeps the Highway Trust Fund balance relatively constant. The obligation limitation for 2004 is $29.3 billion – this is a 6 percent increase above the President's amended request for 2003. When comparing the President's 6-year surface transportation reauthorization proposal in total -- including highways, highway safety, transit, and motor carrier safety -- to the six years of TEA-21, the President proposes an overall increase of 19%.

I've already discussed highway safety. Highway fatalities claim more than 42,000 Americans each year and vehicle accidents cost an estimated $230 billion. Reducing this tragic statistic is "priority one" at the National Highway Traffic Safety Administration. The President's budget request includes $665 million for NHTSA to support its mission -- to reduce fatalities, prevent injuries, and encourage safe driving practices. $447 million of NHTSA's 2004 funding request will support grants to States to enforce safety belt and child safety seat use and reduce impaired driving.

At DOT we are also working to keep our highways safe through the work of the Federal Motor Carrier Safety Administration – by focusing on ways to prevent fatalities and injuries resulting from accidents involving commercial motor vehicles. The 2004 President's budget request includes $447 million to address these problems, including $174 million dedicated to strengthening truck and bus safety standards, ensuring compliance with safety regulations, and supporting inspection programs that keep unsafe trucks off our roads.

We will also continue to emphasize a comprehensive safety inspection program at the southern border so Americans can be assured that trucks entering the United States from Mexico meet U. S. Federal safety regulations. The President's request provides $223 million for Motor Carrier Safety Grants to States to ensure aggressive State enforcement of interstate commercial truck and bus regulations.

Another way to improve transportation safety is to continue to encourage the use of our transit and rail systems by the millions of Americans who use them to get where they need to go. Public transportation is a dependably safe and efficient mode of transportation. The President's 2004 budget request includes $7.2 billion to strengthen and maintain our public transportation systems.

This request includes a proposed streamlined and consolidated program, giving States and localities additional flexibility to meet the mobility needs in their communities, efficiently and effectively. The 2004 budget request includes $1.5 billion to fund 26 "new starts" projects that will carry over 190 million riders annually when completed.

Included in the Federal Transit Administration's funding envelope is $145 million to support the President's New Freedom Initiative to reduce barriers for persons with disabilities who wish to enter the workforce.

Having touched on DOT's surface transportation programs, I'll turn to the reauthorization of our aviation program. We will soon release policy details of our aviation reauthorization proposal; however, the President is requesting $14 billion for 2004 for Federal Aviation Administration programs.

Because travel demand for air service will inevitably return to and exceed pre-9/11 levels, we cannot afford to reduce our commitment to investing in the nations air traffic control system and our airports. Equally important, we cannot take our eye off the safety goal: to reduce aviation fatality rates by 80 percent over the period 1996 to 2007.

To meet both safety and mobility needs, the budget proposes to spend a greater portion of the accumulated cash balances from the Airport and Airway Trust Fund. The President's budget request and our reauthorization proposal maintain current levels of aviation infrastructure investment, and expand FAA's safety staff, including the number of air traffic controllers needed as FAA faces anticipated controller retirements.

Let's turn now to the railroads. First Amtrak. Amtrak faces severe and persistent financial challenges. The Administration has asked Congress to adopt reforms that will strengthen Amtrak's business operations and financial condition. But Amtrak continues to request funds to maintain their current business structure and services. The Federal Government simply cannot afford business as usual at Amtrak.

The President's 2004 budget request includes $900 million for Amtrak of which $229 million is for capital maintenance and $671 million is for operations and for implementing restructuring and management reforms for passenger rail. This is a funding level with a message: Amtrak must undergo significant reform.

Passenger rail is an important component of our nation's transportation infrastructure. We stand ready to work with Congress and the states in the upcoming reauthorization to create an intercity passenger rail system that is driven by sound economics, fosters competition, and establishes a long-term partnership between states and the Federal Government to sustain an economically viable system.

In addition to passenger rail subsidies, the President requests $189 million for the Federal Railroad Administration aimed at enhancing safety, by reducing rail-related accidents and ensuring the safe transport of hazardous materials throughout the rail system.

The movement of hazardous materials is a priority focus for the Research and Special Programs Administration (RSPA). RSPA oversees the transportation of hazardous materials, including America's 2.1 million miles of gas and oil pipelines. The President's 2004 budget request provides $132 million – including $67 million specifically targeted towards pipeline safety initiatives.

Finally, I want to share with you the President's request for our maritime programs. The Maritime Administration (MARAD) supports essential transportation and intermodal connections for domestic and international trade. The President is requesting $219 million for MARAD. One of MARAD's continuing challenges is the disposal of obsolete ships that potentially pose an environmental risk to our nation's waterways. The 2004 budget request includes $11.4 million for removal of the highest risk ships.

The 2004 budget request also includes funding of $14 million for the Saint Lawrence Seaway Development Corporation, which supports domestic and international trade as well.

My prepared remarks focus on only a part of the whole picture. Yet each organization within DOT contributes indispensably to accomplishing the DOT goals

I have outlined. In addition, I am proud to note that DOT is working hard to address the President's Management Initiatives in order to improve departmental efficiency and customer service.

To conclude, President Bush's 2004 budget request makes a very substantial commitment to ensuring a safe and efficient Federal transportation system for all Americans. Thank you again for the opportunity to testify today. Secretary Mineta and his management team will work closely with Congress as you consider the 2004 budget and I look forward to responding to any questions you may have.

Chairman NICKLES. Secretary Jackson, thank you, and we will include your remarks, and I appreciate your presentation. Let me just ask you a couple quick questions, and then we will go to our committee members.

You are going to be asked repeatedly and maybe—the recommendation that you have for highways is a total of $29 billion?

Mr. JACKSON. $29.3 billion is the total Federal aid highway obligation limit.

Chairman NICKLES. The bill that is just now being passed is $31.8 billion or something like that.

Mr. JACKSON. That is what I am told.

Chairman NICKLES. So many people will come to you and say, well, wait a minute, we are having a reduction. How do you justify or explain that reduction in highway funds? Granted, I mentioned historically it is a 60-percent increase from where we were just a few years ago, in 1998, I believe. But, still, the highway users, when they receive those funds, they only want to go up.

Mr. JACKSON. Yes, sir.

Chairman NICKLES. So how do you explain that?

Mr. JACKSON. It is an excellent and important question, and I appreciate it, and I will try to unpack it in a couple of different ways.

First, the Administration supports the principle that receipts into the highway program should fund the highway program.

In addition, we have offered to spend down the trust fund balances by slightly over $1 billion annually over the course of this 6-year reauthorization cycle, leaving about a $14.6 billion balance at the end of this period. It fluctuates above and below that during the course of this period, but call it $15 billion, and we think that is a prudent balance in the trust fund. All of those moneys are obligated, and if the States asked us to spend them out at a rate that is different than our historical rate, we would be obligated to pay those funds. So we think that is a prudent balance.

Chairman NICKLES. Secretary, let me ask you a question. You mentioned all the funds in the trust fund are obligated. You mean there are already existing contracts, highway contracts, out in the States? Those contracts are initiated so if there is a trust fund balance of—of 20?

Mr. JACKSON. About $15 billion is what is projected in our proposal for the course of the reauthorization cycle.

Chairman NICKLES. What are the existing obligations against those trust funds right now if you just stopped? If we completed every contract that is on the books, how much——

Mr. JACKSON. About $42 billion, roughly. I can explain a little bit. There is a pretty standard spendout rate for our obligations. Approximately 68 percent outlays over the first 2 years, and then you spend out the remaining funds over the next seven years. So we have a lot of experience and a pretty clear picture about how these obligations spend. But the first point here is that we have proposed to spend down the trust fund by a little over $1 billion a year. That is part one.

The second part gets us into the so-called RABA discussion. In TEA–21, the target obligation level set by the authorizers was $27.18 billion—$27,180,000,000—in 2002. We had, however, the benefit of a $4.5 billion RABA, revenue aligned budget authority, plus-up. It is like this. I can explain it as working in a regular job where you have a salary, and if you get the benefit of a bonus at the end of the year you have that added to your salary and that to spend. That is exactly where we were in the year 2002 with the States. We had a baseline target that the bill authorized for us to shoot for. That is the $27 billion figure. But the economy was doing very well, and we had created a mechanism in the previous authorization to allow us to enjoy the benefit of that booming economy.

What has happened is that people have come to expect that not just their base salary, but also their bonus, is their entitlement. That is the problem that we are facing here. The trust fund revenues simply will not justify paying at this level. If we took the $31.8 billion number and we simply adjusted that for inflation over the course of the next 6 years, the Highway Trust Fund would be bankrupt by the end of this reauthorization cycle. So the Administration is saying that we have put a proposal on the table that is prudent. It is balancing what is a difficult set of decisions for the Nation at a time when there are tremendous strains on our budget and tremendously important priorities to choose from.

So we think it is a prudent budget. We think it is a fair budget. We think it is a reasonable budget. But most of all, it is a budget that lives within the context of the existing law.

Chairman NICKLES. Secretary Jackson, thank you very much.

We have several members. I am going to ask all of our members—and I was trying to keep my remarks with 5, 6, or 7 minutes. I would like to ask all members to do that as well.

Senator Conrad.

Senator CONRAD. If the Chairman would alert me at the end of 5 minutes, I would appreciate that so I don't go over either.

Mr. Jackson, you are familiar with the conditions and performance report on highways done by the Department of Transportation?

Mr. JACKSON. Yes, sir, I am, Senator.

Senator CONRAD. Is my reading of that correct that they are saying to maintain the current system we would need $41.2 billion a year?

Mr. JACKSON. That is the report's finding, yes, sir.

Senator CONRAD. The investment needed to improve the system, $53.4 billion? That is my reading of the report.

Mr. JACKSON. That is the finding of the report, yes, sir, but it depends on what you mean by "improve." You could obviously improve the highway system by every dollar that you add into it if you spend those dollars wisely.

Senator CONRAD. But I guess we would go back to the fundamental there, to maintain the current system, $41.2 billion. So would you agree that a budget that the President proposes of $29.3 billion, according to your own Department's analysis, will not maintain the current system?

Mr. JACKSON. I think we can use our money better, and we can address the concerns raised by this report by spending wiser and spending appropriately. Let me say that in my experience with the Department dating back to the last Bush administration, the Congress has never appropriated these target-level funds. They are based on descriptions and analyses of what professionally the highway engineers would like to see as a maintenance level, and to my knowledge, those levels have never been reached in appropriations for us in recent times.

Senator CONRAD. So would I be correct in concluding that you don't agree with your Department's report that $41 billion is necessary to maintain the current system?

Mr. JACKSON. The report of the Department lays out an approach and a program to use $41 billion wisely, and I am telling you we don't have $41 billion to use.

Senator CONRAD. Let me just ask you this: You have indicated that you are using all that the trust fund has available. Are you familiar with the Congressional Budget Office's runs that have looked at assuming that additional revenue would be credited to the trust fund from the President's proposed policy of transferring 2.5 cents a gallon in ethanol tax to the trust fund that currently is being credited to the general fund and how much money that would raise? I am told that the CBO's runs indicate that if we simply grew at the rate of inflation from the 2003 level, the trust fund balances would never fall below zero and never trigger a gas tax increase, but that $3 billion would be available for 2004 above what the Administration has recommended.

Mr. JACKSON. I am not familiar with that study, sir. Our own internal Administration projections estimate that moving the 2.5 cents from the general fund to the Highway Trust Fund will yield $600 million annually.

Senator CONRAD. Yes, that is exactly what CBO has found, $600 million a year, but that that would permit an expenditure of $3 billion more in 2004 than what the President has recommended.

One other scenario that they have run was starting at $31.1 billion in 2004, growing at the rate of inflation thereafter, a balance of $5 billion would still be maintained in the Highway Trust Fund, and that 2004 funding level of $31.1 billion would be $1.8 billion above the President's recommendation. Are you familiar with that analysis?

Mr. JACKSON. I have not seen that run, sir. I would be happy to look at it. The $5 billion is what we would consider a perilously low balance in the Highway Trust Fund. We have looked at these numbers very carefully. There certainly is a zone for reasonable disagreement about what an appropriate level of balance is in the trust fund. But that level would be perilously low and below where we think it should be. That strikes me as approximately a 2-month reserve.

Senator CONRAD. That is the calculation, a 2-month reserve.

Let me just conclude by saying that when you say the Nation can't afford $900 million more for Amtrak, it strikes me that this administration is recommending a $1.5 trillion tax cut. That to me is unaffordable. This is a matter of choices. We are going to have to make choices. I don't think it is a good choice to decide we are going to cut highway and bridge construction in this country and lose 171,000 jobs when the economy is weak. I must say that doesn't make sense to me.

I thank the Chair.

Chairman NICKLES. Senator Conrad, thank you very much.

Senator Burns.

Senator BURNS. I am going to pass. I am working on something. I have some information coming.

Chairman NICKLES. Senator Allard.

Senator ALLARD. I want to get some clarification on the unobligated dollars that we have in the Highway User Trust Fund.

Mr. JACKSON. Yes, sir.

Senator ALLARD. Now, the Chairman was talking about obligated dollars. I guess my question is: Do we have any unobligated dollars at all sitting in the trust fund?

Mr. JACKSON. No, sir. All of the trust fund balances are obligated. That is different than, for example, the FAA's AIP program where we do have some portion which is not obligated.

Senator ALLARD. OK. So just so we get this and I understand it correctly, there are no funds in the highway transportation budget that have not been obligated?

Mr. JACKSON. That is correct. That is what the balance is, all of that roughly $15 billion.

Senator ALLARD. So when city and county people come to us and say we want the unobligated amounts, what they are wanting is a lower balance in the obligated funds, which may mean if we get into a shortage of money that somebody's project that was started doesn't get completed.

Mr. JACKSON. Exactly.

Senator ALLARD. OK. Generally what likelihood do we have that we will not be able to measure up to those obligations that we have now in the trust fund? Do you have confidence that we'll be able to meet all those obligations we currently have?

Mr. JACKSON. I do. We think that the level that we have proposed, which reduces the trust fund balance to about $14.6 billion by the end of this authorization cycle, is a fair and a prudent balance to maintain in the account, and that is based on a fair bit of history and a lot of close scrutiny.

Senator ALLARD. You are willing to spend out the $1 billion?

Mr. JACKSON. Yes, sir.

Senator ALLARD. That has been obligated?

Mr. JACKSON. Right. So——

Senator ALLARD. That is $1 billion out of somebody's project that is going on out there.

Mr. JACKSON. It is $1 billion——

Senator ALLARD. Are you comfortable with that?

Mr. JACKSON. Yes, sir, we are. We are accelerating down, we are spending down that balance a little bit, and we think that a modest spend-down—it is sort of hard for me to think of a spend-down of $1 billion as modest, but in the scheme of this program, that spend-down level seems reasonable to us. We have had extensive conversations in the Administration about that, and that is the comfort zone.

Senator ALLARD. So that is based on current law?

Mr. JACKSON. That is exactly right.

Senator ALLARD. So the Congress would have to be careful that they don't enact laws in what length of period that might have an adverse impact on the balance of that? Because you are assuming under current law that there will be money there that you can spend down your obligated dollars, and if we do something that would reduce the collection of fuel dollars in some way or another, it could have even a greater impact on those dollars, right?

Mr. JACKSON. Yes, sir. It assumes that the sources of revenue proposed in the President's budget are adopted. It is basically not proposing a change in any of the user fees that drive revenue into the trust fund.

Senator ALLARD. I guess it is possible, if things really go bad, that you would come back and ask for a tax increase if you some way or another saw that trust fund get into trouble and we have overobligated it, right?

Mr. JACKSON. That is not something that we are contemplating. We are trying to find a reasonable proposal and a fair proposal that doesn't require any changes in taxes and user fees.

Senator ALLARD. You are 100 percent confident of that, 90 percent, 75, 50 percent?

Mr. JACKSON. I am very, very confident that it is a fair and prudent level to maintain.

Senator ALLARD. So 90 percent confident.

Mr. JACKSON. And RABA, the revenue aligned budget authority, does provide a mechanism to reduce the obligation limitation if the economy does not perform and revenues into the trust fund are below where they were anticipated to be. That is what happened in 2003. The trust fund didn't generate enough money to support the $27 billion baseline, not to mention the $31.8 billion funding level which we had enjoyed as a result of the boom economy in 2002. However, when we adjusted our 2003 budget request downward per the law, it turned into a no-starter. Frankly, the Administration, after some brief discussions with the Congress, agreed that we should at least use additional funds to bring us to the $27 billion baseline level. I understand that Congress is proposing to pass legislation at the $31.8 billion level, which is to add the bonus that came through the good years to 2003 as well, even though the revenues into the trust fund don't support that level of expenditure.

Senator ALLARD. Is that a transfer out of general revenues? Or where is that?

Mr. JACKSON. Well, it comes out of the trust fund money and does reduce the trust fund balance, but it is a deficit impact because this is money that we hadn't intended to spend on the program.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman NICKLES. Senator Allard, thank you very much.

Next I will call upon our distinguished colleague, and the first time I have had him join our committee during our hearing. Senator Byrd. Senator Byrd, just for your information, we usually call on people, recognize them on their order of appearance. If you wish to defer, we will be happy to accommodate you as well.

Senator BYRD. Thank you, Mr. Chairman.

Mr. Jackson, does the Administration support Amtrak serving as their national passenger rail system?

Mr. JACKSON. We do believe that Amtrak is an essential part of intercity passenger rail for the foreseeable future, although we have tried to lay open the prospect that, some competition could be injected into intercity passenger rail in a modest and thoughtful way. We have had expressions of interest from other competitors or potential competitors of Amtrak to provide some service of that sort.

Senator BYRD. But the Administration does support Amtrak as the national passenger rail system?

Mr. JACKSON. We have proposed $900 million worth of support for Amtrak in our 1904 budget, yes, sir.

Senator BYRD. When will it begin to propose a realistic funding level that will address Amtrak's long-term viability?

Mr. JACKSON. This year we hope that the reauthorization cycle, Senator, will allow us to take a good hard look at the fundamental business problems that face Amtrak. Working with you and your colleagues in the Senate and with the House, we hope to come up with a plan that would allow them to be viable for the long haul. We believe that fundamental business reforms are needed. I will say that I very much think that the current president of Amtrak, David Gunn, is making some very important strides in bringing some business discipline to Amtrak, so we hope to continue to work closely with them as well.

Senator BYRD. Mr. Gunn took the reins at Amtrak just last spring. He was given the mandate to strengthen Amtrak's performance, and yet it seems as though the Administration is constantly dictating reforms to Mr. Gunn and the Amtrak board. Mr. Gunn has asked for the time and opportunity to meet the mandate given to him just a few months ago. Should we not let him do his job and find the best plan for Amtrak?

I think that it is really the responsibility of Congress and the Administration and our partners, which include Amtrak, include the States, and include all the people with equity in this system to set a vision for Amtrak and tell them where we think they need to go, and then David will be a good executive and take the railroad where the Congress and the Administration point him to. So the budget that was placed before us just earlier of $1.8 billion is really a budget that does not fix Amtrak. It just tries to stabilize a patient that is already in the ICU, and what we think we need to do is figure out not just how to stabilize the patient, but to make the patient healthy, and so we think that the time spent in reauthorization to look at all the core problems that we have had for 30 years and see if we can find a better way of doing business is time well spent.

Senator BYRD. I think the Administration will be supportive of Amtrak's long-term viability. I live in an area of the country that does not have much of an opportunity. It cannot count on much by way of airline service, and when it comes to building highways, we have spent enormous sums per mile on highways. We have to have some kind of a rail system we would think, and I hope that the Administration will be realistic when it comes to dealing with Amtrak.

If the $1.8 billion budget request from Amtrak sustains the patient, a $900 million budget from the Administration kills.

Mr. JACKSON. Sir, I think that the way I would characterize it is that the patient is in ICU and we need to look at what they need to live, and then we need to see where they need to go. The proposal to maintain business as usual for the next 4 years while we try to figure out how to run the operation is not, in our view, a viable proposal. We ought to face the tough choices now and tell Amtrak where it needs to go and what it needs to do to make fundamental business reform. So we do believe that Amtrak and intercity passenger rail are vital parts of the transportation network. We need intercity passenger rail, and we will support it and work with you as we take on the reauthorization challenge.

Senator BYRD. I hope we will do that. We are supportive of the airlines when they lose money. We are quick to come up with a bagful of money when the airlines need money. We are helpful to the waterways. I have been around here since—I was with Mr. Eisenhower when he proposed the highway system. I voted for it, and have voted for the moneys to sustain it over these many years. I have voted for appropriations for the Appalachian highway system. When it comes to the rail system we want to pinch pennies. We expect too much. We need a rail system in this country. I would hope that the Administration would keep that in mind. The States have already great financial burdens on them. They are experiencing severe budgetary difficulties. I hope we are not suggesting that the States should cut their programs and public services even further to finance a national rail system.

Keep this on mind on the rail system, will you, please?

Mr. JACKSON. Yes, sir.

Senator BYRD. As to the Highway Trust Fund, even in the wake of the disturbed funding increase accomplished through TEA–21, we continue struggling to maintain the current inadequate conditions of our highway network.

Mr. Phil Gramm is here. He was so helpful as we worked together a few years ago on our highway bill.

As an example, the Road Information Program reports that one in four of our Nation's bridges is classified as deficient, and that the average age of bridges in the U.S. is 40-years-old. In the light of the action by the Conference Committee, does the Administration stand by its proposed fiscal year 2004 highway funding level of $29.3 billion which will be a $2.5 billion cut from the level of funding tentatively due to be set for fiscal year 2003?

Mr. JACKSON. Yes, sir. Although, Congress has not yet passed this bill, I understand that it is headed in that direction. The Administration is mindful of the many, many challenges that face the Congress in making prudent budgetary decisions, and we think that $29.3 billion is a prudent funding level for this program.

Senator BYRD. It has been estimated that every one billion dollars of spending on our Nation's infrastructure produces approximately 47,500 good paying jobs. With the Administration's stated focus on the creation of new jobs to replace those that have been lost during the past 2 years, why has the Administration chosen not to avail itself of the opportunity to invest in the creation of approximately 132,750 jobs for our economy.

Mr. JACKSON. Well, the understanding that transportation investment does help stimulate economic growth was a part of the consideration that impelled us to add $1 billion a year to the program. The Administration takes the position that in order to stimulate growth within the economy, the most efficient tools are the tax policy tools that apply across the spectrum of the economy as proposed by the President.

Senator BYRD. When it comes to the matter of future highway spending, your formal opening remarks, Mr. Jackson, state that the Administration will squeeze everything we prudently can from the trust fund, but the President's budget request does not propose new user fees. Your budget request for the FAA have included appropriations from the General Fund totaling about $6 billion over the last 3 years. You have asked for these moneys out of the General Fund because you know that there are not adequate resources in the Airport and Airways Trust Fund to pay for it. If, as you claim, the Highway Trust Fund does not have adequate resources to address all of the infrastructure spending that we need to address the congestion problem, why have you not requested appropriations from the General Fund to address this need?

Mr. JACKSON. On the whole, the Administration believes that we should try earnestly to fund the highway needs with money generated by the trust fund, that money in to money out of the trust fund is the right way to provide stability and long-term common sense for the country on surface transportation investments, in this hugely important program. So we feel like that we ought to try to live within the walls that we have constructed there, and that is what our proposals represent.

Senator BYRD. Do I have any time left, Mr. Chairman?

Chairman NICKLES. I have given you about twice as much as——

Senator BYRD. Have you really?

Chairman NICKLES. I was very interested in your questions.

Senator BYRD. Oh, thank you. Thank you. I have some more interesting questions. [Laughter.]

Chairman NICKLES. Well, we can have a second round. I would like to let other senators ask a question.

Senator BYRD. Well, thank you very much.

Chairman NICKLES. Thank you, Senator Byrd, and we are delighted to have you on this committee.

Senator CORNYN.

Senator CORNYN. Thank you, Mr. Chairman.

I would like to, Mr. Jackson, ask a few questions about Amtrak as well, because like Senator Byrd, I would like to see Amtrak succeed, but things are not looking too good. I note that the omnibus, the Conference Committee approved a $1.1 billion for Amtrak for 2003, but your budget request for 2004 is $200 million less than that; is that correct?

Mr. JACKSON. Yes, sir.

Senator CORNYN. Could you sort of describe for me sort of what your vision is, what the Transportation Department's vision is about the future of Amtrak? Do you envision it as a national passenger rail system? I hear you talking about intercity, and certainly we know that in places like the Northeast it is perhaps more financially viable, where people are closer together.

Mr. JACKSON. Yes, sir.

Senator CORNYN. But do you envision it continuing as a national rail system?

Mr. JACKSON. I do think that a network of intercity rail service is something in our future and should be in our future, but precisely what that network will look like and how we will manage it in a businesslike and publicly responsible fashion is the subject for the reauthorization debate. We do not go into that debate with an assumption that we will do everything that we are doing today, nor does it assume that we are limited and not able to add different and new types of service in the future. It says that we just have to figure out how to do it in a common sense businesslike way. So we are asking for some reasonable competition, and we are asking for States and localities to help pay the load if there is a need for an operating subsidy, not unlike the way that we manage our Federal transit programs. We are, at the Federal level, focused on the infrastructure investment, and if that infrastructure investment needs an operating subsidy, we feel the States should share that burden. Senator Murray's State is an excellent example of a State that has stepped up to the plate and made a very significant investment in railroad service.

So we are trying to encourage more States to do what her State has done. We are looking for a way to work with the States in a prudent fashion. When Secretary Mineta and I met with the President on this topic, he said that we want to make change, but he is mindful of what his previous job was as Governor of your State, sir. He knows that the States are pressed and that we have to be able to put a proposal on the table that is prudent, measured and allows us to transition from where we are today to where we need to be. We need a separate plan for the Northeast corridor that can be understood in much different economic terms than our long-term rail system.

Senator CORNYN. Well, I am intrigued. For example, you talk about competition. What would competition look like for something that is bleeding as much red ink as Amtrak is now? Who do we expect to compete to lose money on the order that Amtrak has been losing money?

Mr. JACKSON. Well, what you would have to decide is whether you can run a railroad with a more cost effective operating structure than Amtrak has done. I believe the answer to that is yes. I believe if you talk to the President of Amtrak, he would tell you that he can reduce operating expenses as well. For the last two years, I have had the privilege of serving on the Amtrak board representing the Secretary of Transportation. I have had the benefit of looking at that operation, and, I certainly believe that we can do better.

But the idea is, if a State wants to guarantee that a given route is run, it could run a competition among any interested parties to operate rail service in a given corridor. Then if some sort of subsidy is needed, the State would have to face up to the question of whether among all the transportation investments that it has to make, this is a reasonable and prudent subsidy. Right now the States do not have to make those investments. They just wait for the Federal Government to fund the program.

Senator CORNYN. Let me ask you about that last point. Do you have a spreadsheet, or does it exist somewhere in the Department of Transportation, a comparison of the per capita—the per mile cost of the Federal—excuse me—the subsidy that the Federal Government pays for rail, air and highways, and how those compare?

Mr. JACKSON. I am certain we can get you some numbers like that. In the case of Amtrak we have figures about the individual subsidies for individual routes. That data is fairly widely available from Amtrak, from the Inspector General, and from the Department and other analyses. In other modes of transportation it depends on whether you characterize user fees as a subsidy or not. If you are paying highway taxes, you are paying for what you get.

Senator CORNYN. I would be interested to see if you could put your hands on something like that or——

Mr. JACKSON. I would be happy to put something like that together.

Senator CORNYN [continuing]. Or approximating that, I would be interested.

Mr. JACKSON. Yes, sir.

Senator CORNYN. Finally, and quickly, as you know, my State has a 1,200 mile border with Mexico, and as a result of NAFTA we have seen a tremendous increase in the amount of traffic, commercial traffic, which benefits the Nation, coming across our roads, so obviously they are burdened with additional traffic. There is concerns, of course, about safety issues. No one wants to look in their rear view mirror and see an 18-wheeler with bald tires and bad brakes bearing down on their family. But can you sort of describe in summary fashion what this budget includes in terms of enhancing the safety of our roads along the border and maintaining those roads to accommodate that huge increase in traffic, as well as population?

Mr. JACKSON. Yes, sir. First of all, the budget does include some very considerable investments, and I would be happy to pass very detailed budget information to you about the border investment in particular. But let me just characterize it this way for you to get oriented on it. In the appropriations act 2 years ago, we had quite a bit of conversation about how to meet our NAFTA obligations and what type of investments were needed at the border for safety inspectors and for weigh-in motion or weigh scales to do the business of enforcement. We have made some very, very considerable investments there. The Federal Motor Carrier Safety Administration's enforcement tools at the southern border have grown by about 25 percent overall, so we have a very large number of people. We have invested in border crossing technology with the States of Texas, California, New Mexico and Arizona, but a very large part of that investment went into Texas. We are awarding safety education grants for the States that have this border work to do with us, so we are making some considerable investments and putting a very considerable number of our staff and enforcement folks into the field in our border states.

Senator CORNYN. Like the Amtrak information you are going to get for me, that comparison, I wonder if you could help direct my staff and I to the specific investment that is made under this proposed budget to deal with that——

Mr. JACKSON. Yes, sir, I would be happy to put a little package of that together and convey it to you, and we would be happy to brief your staff if you would like detailed questions answered on any of those issues.

Senator CORNYN. Thank you very much.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Cornyn, thank you very much. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman. Welcome the witness.

First I would observe, I would like to see some of those subsidy numbers, too, for various modes of transportation.

Mr. JACKSON. Yes, sir, Senator.

Senator CORZINE. Second, I would identify with a number of the Senators who have talked about the difference between a conditions and performance report with regard to highways, and what needs to maintain, and then obviously to improve the system. But I note with regard to mass transit the percentage differences between those are even greater than they are actually for highways. Got almost double, over double, just to maintain the mass transit system, if I have read your report right, 7.2 is the number, flat line number year to year, and 14.9 is the maintenance number, and $20.6 billion is suggested as bringing it up to a level that would improve the condition and performance. Am I right on those numbers?

Mr. JACKSON. I think that you have the basic numbers from the report as printed.

Senator CORZINE. So I think the need of maintenance and improvement with regard to mass transit is equally important, and certainly in our highly urbanized areas it is true.

I just want to make sure that I am reading this that we are not changing—you are not suggesting changing the formulation that funds mass transit on its relative basis to highway funds.

Mr. JACKSON. We are suggesting making some awfully important programmatic improvements in it, but we are still funneling money into the transit program through the trust fund mechanism that is in place. Actually, transit——

Senator CORZINE. At roughly the same percentages, if I have——

Mr. JACKSON. Actually, the transit portion grows by 2 percentage points relative to the previous authorization cycle and the money that is required to be spent out of the Highway Trust Fund.

Senator CORZINE. I have a little trouble tracking all the math, but——

Mr. JACKSON. I don't blame you. There are some pretty big numbers.

Senator CORZINE. I would say that flat-lining mass transit in a world where we clearly have new safety needs in the context of homeland security is a tough task. That is before any allowance for inflation, which is an absolute down. So I think in some context, given the challenges for our mass transit system to be secure for those that use it, and given that many of the identified targets that we hear about or potential targets identified, I think the overall decrease that is actually happening to mass transit with a flat-line number is really substantial relative to performance and service to the communities that are at hand.

Mr. JACKSON. Let me help unpack that one just a little bit, if I could, Senator, because I share your concern about the importance of transit and the focus on security. We certainly feel like the transit agencies that operate in your State and in the New York region just were phenomenal stars—the story of well-trained and professional folks—on 9/11. I can help unpack it a little bit this way.

First of all, the Administration's proposal gives States a significant amount of new flexibility to address their needs rather than have very stovepipe categories and say they can only apply this much for buses, this much for research, etc. We are trying to say give the States the flexibility to use that money. That is a very significant help.

Second, we are proposing a 25-percent increase in the New Starts program, which funds is our major transit investments, and, finally, a 20-percent increase and support for rural areas. So that is a significant thing.

Let me talk about the top-line dollar. You are a man who understands top-line dollars—and bottom-line dollars.

Senator CORZINE. I like bottom-line dollars.

Mr. JACKSON. Those, too. Well, I will talk to you about the bottom line then. $1.2 billion was flexed out of the Highway Trust Fund to support, mass transit programs in 2002. So we created in TEA–21 the capacity to take Highway Trust Fund money and use it on transit projects. Frankly, you can go both ways. If I remember correctly, $2 million went from transit accounts into highways and $1.2 billion went the other way.

So when we looked at the experience of States and how they were using the money with their localities, what we found is that there is a significant kicker that is embedded in the program that has grown over time and that communities have come to understand and use to make effective transportation investments. So I think that one thing that is not present on that bottom-line number of transit funding is this experience of flex funds being used to substantially improve what we have got there. We expect that to continue.

Senator CORZINE. I know I am getting down to the long end of my 5 minutes. I want to totally identify with the series of questions that Senator Byrd asked with regard to Amtrak. I am sure other folks will. I do want to emphasize, though, that tunnel safety money and safety money with regard to Amtrak has not flowed, either from FEMA or from the Transportation Department, at least to my knowledge, for the on-the-ground folks like the Port Authority of New York and New Jersey, and I suspect we will hear the same thing from Maryland and other places. I think that for those safety considerations and security considerations, it is money out of one pocket which is continuing—you may call them stovepipes, but, you know, it is a very hard choice that we are putting on States that are actually in fiscal crisis right now and have constitutional responsibilities to balance their budgets.

I understand we have overall budget constraints. That is why we are having these hearings. But this is a very, very tough choice that we are backing our States into making.

Chairman NICKLES. Senator Corzine, thank you very much.

Senator Murray.

Senator MURRAY. Thank you, Mr. Chairman, and thank you, Mr. Jackson, for being here today, and I join my colleagues in sending with you our speedy recovery wishes to Secretary Mineta.

Mr. JACKSON. Thank you, Senator. I will pass those along.

Senator MURRAY. Thank you. The conference agreement that closed this morning provides close to the level of funding that Amtrak requested for 2003 when you consider the decision to delay the $100 million. I think we have $1.15 billion for 2.3, and you have heard the concern expressed here on the Budget Committee about that today.

Last year, in a hearing in front of the Transportation Appropriations Subcommittee, you testified that the 2003 budget request of $520 million was a place holder and that your Amtrak reauthorization proposal would be coming to Congress shortly. As you and I know, we have had this conversation a number of times. Your 2004 budget, which we now have, contains $900 million for Amtrak, which is $250 million below what we agreed to last night. But Amtrak is telling us they need $1.8 billion to stay functional.

You have said now for over a year that we are going to get an administrative proposal on reauthorization. Can you tell us when we expect to see that?

Mr. JACKSON. We have a proposal that is reaching the final stages within the Department, and we expect to move it up in a timely fashion this spring. I can't give you an exact date, but I can tell you that the Department has had extensive conversations within the Administration. We are absorbing those into some actual——

Senator MURRAY. Are you planning on putting a written proposal before Congress?

Mr. JACKSON. We are, yes, ma'am.

Senator MURRAY. I know you represent Secretary Mineta on that Amtrak board and know all of the tremendous problems facing it. Do you think that if we appropriate your request of $900 million for Amtrak in 2004 that we will be forced to cut routes or services?

Mr. JACKSON. I think that we will have to look at what the Congress chooses to do in the reauthorization to answer that question fully. Just to give you an example—I am not trying to dodge the question, but if every State were to belly up to the bar the way your State has done in making a partnership commitment with Amtrak——

Senator MURRAY. With current State budget deficits, I don't know how much longer any of them will be able to do that.

Mr. JACKSON. Right. Well, there is a rather large budget deficit that is associated with this year's budget Federal proposal as well, and so we are all juggling those multiple good objectives. So I think that we have to dig into this reauthorization program. We look forward to engaging in that.

Senator MURRAY. I look forward to seeing your written proposal when it comes.

Mr. JACKSON. OK.

Senator MURRAY. I did want to thank you. Your budget includes $75 million for a Sound Transit link light rail, and I want to thank you and Secretary Mineta and FTA Administrator Jennifer Dorn for really working hard on this project. It is an extremely important one for the Seattle-Tacoma area. I wanted to ask you if in putting this money in your budget, is it your Department's belief that the revised $500 million FFGA will be signed this year?

Mr. JACKSON. I can do you one better than that. We hope it will be signed before the end of this fiscal year, and we are having a very good relations in the conversation with Sound Transit. So I am very hopeful. I think Administrator Dorn——

Senator MURRAY. Do you know when you are going to send it to Congress for our review yet?

Mr. JACKSON. I don't know that. I know that they are working very hard on it, and at the risk of being obsequious, let me say that we are very grateful for your intervention in this particular application. It has made a big difference, and thank you for your work in bringing this project to the point where it can be considered for an FFGA this year.

Senator MURRAY. Great. Thank you. I look forward to working with you again. Thanks for your work on that.

One last question really quickly. I wanted to follow-up on Senator Cornyn's question on the Mexican border. You know the Ninth Circuit decision, which I noticed you didn't answer in your response to him. The transportation appropriations bill required you to beef up the safety checks and inspection procedures, and now the Ninth Circuit Court of Appeals has forbidden you from opening the U.S.-Mexican border because there was not an environmental impact statement, I believe is the court decision. Do you know how long it is going to take you to prepare that EIS?

Mr. JACKSON. We don't. We did an environmental review, and I may not have the exact term of art for what it is called. It is an environmental assessment shy of the full-blown EIS. We believe that that was the appropriate level of review for this particular project. Regrettably, the Ninth Circuit Court did not share that view, and we are in the process of discussions with the Justice Department on our——

Senator MURRAY. Do you have an estimation of when the border will be open at this point?

Mr. JACKSON. I don't. We need to reconcile this issue. It is pending a legal matter and so I need to defer to the lawyers who have the lead in this area to help us take an appropriate course of action.

Senator MURRAY. Well, we did appropriate money for truck inspectors on the border and inspection stations. What is being done with that money since the border is not open?

Mr. JACKSON. Right now we are trying to bring additional focus to truck safety enforcement in the border zone, which is, as mentioned in our previous discussions, a priority issue for us as well and part of the overall effort to bring greater scrutiny to border traffic. So we are putting those people to good use. As you know, there are restrictions written in the appropriations language directing that we not take those assets and use them elsewhere in the system. If it turns out that we feel that we should have the flexibility to use those assets in a different way, then we will come back to the Congress and ask for that type of flexibility.

Senator MURRAY. Thank you very much, Mr. Chairman, and thank you, Mr. Jackson.

Mr. JACKSON. Yes, thank you, Senator.

Chairman NICKLES. Senator Murray, thank you very much.

Senator Sarbanes.

Senator SARBANES. Thank you, Chairman Nickles.

Mr. Jackson, I have a number of questions, and I will try to run through them with you very quickly.

Mr. JACKSON. Yes, sir.

Senator SARBANES. Two days ago, the Washington Post had an article reporting that the new security and flight rules for three nearby airports in Maryland—College Park, Washington Executive, and Potomac Air Field—are taking a heavy toll on operations and on employee income and revenues of the airport owners and businesses located there. The three airports are currently operating at only about 15 percent of the pre-9/11 levels. What thought is the Administration giving to compensating these airports and their fixed based operators for their losses in revenue and income during these restrictions? For all intents and purposes, these airports have been closed down, through no fault of their own, for national security reasons. Shouldn't the Federal Government undertake some effort to provide them compensation for their financial losses?

Mr. JACKSON. At this juncture, we have not proposed anything, Senator, but I do not want to close the door on a discussion with you. We do believe that these three airports pose a particular vulnerability for the capital, which has necessitated, similiar to all the general aviation airports in the country, that we impose some specific security restrictions on traffic in and out of these places. As a result of raising the national threat level to Threat Level Orange, we have put some enhancements in place over the last weekend at these three airports.

So I recognize that it makes flying in and out of those three locations more burdensome. I wish that I could——

Senator SARBANES. More burdensome? It, in effect, is putting them out of business. If you are going to treat them as acceptable collateral damage in the fight against terrorism, it seems to me you ought to undertake some program of recompensing them. Simply by virtue of their location, through no other fault of their own, they have had imposed upon them such restrictions that they, in effect, have been closed out of business.

Mr. JACKSON. Well, they have certainly seen their business significantly diminish.

Senator SARBANES. The number of flights in and out of College Park has plummeted from 1,800 a month to 164 last month. They don't even have 10 percent of their previous business.

Mr. JACKSON. The budget for this, I have to say—this sounds like a classic bureaucratic dodge. This is not a DOT budget issue. This is a Secretary Ridge budget item for the Transportation Security Administration. So I don't bring to this table the ability to commit the Department of Transportation to a security program of the sort that you are talking about. But what I will commit to you, sir, is if you would like us to engage with you in a discussion about options on that topic, I would be happy to do that.

Senator SARBANES. Were the limitations imposed upon them a DOT act?

Mr. JACKSON. They are a Transportation Security Administration act, yes, sir, and the Transportation Security——

Senator SARBANES. It seems to me when you carry it to the point of putting somebody virtually out of business, you ought to figure out what you can do to compensate in that situation. We intend to pursue this. You have two problems. One is: Are the restrictions you are imposing reasonable given the circumstances? One could examine that. But I know you are on very high alert and all the rest of it, and it is difficult to raise those kinds of issues in the current environment. But, nevertheless, if you are going to impose these kind of restrictions to the extent of virtually putting these people out of business—that is what it amounts to. I don't think the Federal Government ought to just come along and do that and not do something to make up for it.

Can you take that back to the Department and undertake to look at it?

Mr. JACKSON. Yes, sir, I will. I will tell you that that question has been a topic of debate, and we will take that back for further scrutiny and be happy to follow-up.

Senator SARBANES. All right. Let me——

Chairman NICKLES. But you are basically saying, though, that you believe that is in Secretary Ridge's Department.

Mr. JACKSON. Not to split a budget hair, but the budget money for that program is in Secretary Ridge's Department. DOT didn't get the passback for the Transportation Security Administration in our 2004 budget.

Senator SARBANES. I do think that is a bureaucratic dodge. [Laughter.]

Mr. JACKSON. But I am not trying to give you a bureaucratic dodge because I personally——

Senator SARBANES. Well, I know. You come along and you take the action that causes the problem, and then you say, well, if you are going to get that problem alleviated, you have got to go look somewhere else. Then you go somewhere else, and the other guy says, "I never caused this problem."

Mr. JACKSON. Well, Senator——

Senator SARBANES. "Why are you coming to me? I didn't create this problem." Right?

Mr. JACKSON. Let me be a very non-bureaucratic guy. I hate bureaucratic solutions. I will take the responsibility to do what you asked, which is to discuss this with Secretary Ridge, and get back in a straightforward way with you.

Senator SARBANES. All right. I appreciate that.

Mr. JACKSON. Yes, sir.

Senator SARBANES. Your budget proposes lowering the cap on the Federal match for transit projects to 50 percent. Is that correct?

Mr. JACKSON. On New Starts program, sir.

Senator SARBANES. Currently the cap is 80 percent for both highway and transit projects. Does your budget lower the cap for highway projects as well?

Mr. JACKSON. No, sir. Let me try to unpack this one a little bit as well. The 50-percent match is for the New Starts program—I am going to avoid getting the big budget book here.

Senator SARBANES. What are you doing on the highway projects?

Mr. JACKSON. 80/20 is the standard——

Senator SARBANES. We always had the same match in order not to skew the decision for local decisionmakers as between highways and transit. We didn't want the Federal Government coming along and tipping scales because of the different match. We wanted to leave that neutral so that decisions would be made on the basis of what would meet local transportation needs.

Mr. JACKSON. Senator, let me explain it this way: The core program, the largest portion of our transit expenditures are an 80/20 match. The core program, thank you for the chart—which is $5.6 billion, is formula grant research program. That is an 80/20 match.

Then there is this one fund of approximately $1.5 billion that is called Major Capital Investment Grants. These are very large capital projects, which are intended to be a 50/50 match. We have been working backward from the 80/20, and I will just give you some recent experience on this one. On average, with the funds that States and localities bring to these projects the Federal share for these projects is slightly under 50-percent right now.

Senator SARBANES. But that is because they are willing to make that extra commitment. But when you structure the thing up front for their choice, it is still 80/20 between transit and highways, is it not?

Mr. JACKSON. It is not for this program, but it is for the bulk of the transit program 80/20. For New Starts, our proposal is 50/50.

Senator SARBANES. What is it for new starts in highways?

Mr. JACKSON. We don't have a comparable equivalent program in highways. They are all, of course, as you know, very large investment programs.

Senator SARBANES. So if I am a locality and I undertake to do a new highway project, what is my match?

Mr. JACKSON. 80/20 is the standard.

Senator SARBANES. If I am a locality and I undertake to do a new start transit project, what is my match?

Mr. JACKSON. Our proposal is 50/50.

Senator SARBANES. So you have lost the level playing field, and it seems to me you are tipping the scales.

Mr. JACKSON. We are trying to balance a program which has far exceeded the capacity to meet demand. So what we are trying to say is we can fund more projects if we bring a 50 percent match to it, and we feel comfortable with that proposal because the programs on the table in recent years have managed to bring a 50/50 match to the table and jump-start the——

Senator SARBANES. But you could do the same thing with highways. You could fund more highway programs if you did a 50/50 match. Could you not?

Mr. JACKSON. That is right. That is absolutely——

Senator SARBANES. Don't you have requests for highways far in excess of available funds?

Mr. JACKSON. We have a program that has a long history, and we are sticking to that with the highway program. I am trying to tell you that in a constrained budget environment, we are making a business judgment, which, by the way, has been a very high priority of the Appropriations Committees in the House and Senate, particularly in the House, to push——

Senator SARBANES. It has been a priority of the Chairman of the sub-committee in the House.

Mr. JACKSON. Yes, sir, a very big priority of his.

Senator SARBANES. Not in the Senate. Not in the Senate. You have a comparable situation. You have highway demands far in excess of available money. You have transit demands far in excess of available money. Now, if you are going to reduce the match and you can put a rationale out for doing that, I don't see why you wouldn't reduce the match in both categories. The same logic would apply. You said——

Mr. JACKSON. Yes, but——

Senator SARBANES You can do more highway projects at a 50/50 match.

Mr. JACKSON. It is, Senator, a prudential judgment about how to stretch limited funding in order to support more big transit capital investments, and it is our prudential judgment that this is a fair way to do it.

Senator SARBANES. Fair to whom?

Mr. JACKSON. Fair to the users and to the taxpayers that need these systems and that would otherwise be deprived of the financial capacity to start one.

Senator SARBANES. Let me ask one final question. You state, "The President proposes an overall increase of 19 percent for the next surface transportation reauthorization as compared to the 6 years of TEA–21." Is that correct?

Mr. JACKSON. Yes, sir.

Senator SARBANES. For the last year of TEA–21 transit, was guaranteed $7.22 billion. Will transit get a 19-percent increase in the reauthorization proposal, bringing it up to $8.6 billion in the last year of the reauthorization?

Mr. JACKSON. Transit over the course of the reauthorization period would go up from $36.2 billion to $45.7 billion during the period of this proposed reauthorization.

Senator SARBANES. What would it be in the last year of the next authorization?

Mr. JACKSON. In 2009, the mass transit category will total a little over $8 billion.

Senator SARBANES. That is not a 19-percent increase over the 7.22.

Mr. JACKSON. The 19-percent increase referred to the entire surface transportation program, which grows from $207.252 billion to $247.1 billion.

Senator SARBANES. If transit is not growing, what is growing? Highways?

Mr. JACKSON. Highways is growing and transit is growing, but the overall surface transportation program will grow by 19-percent figure, sir.

Senator SARBANES. Well, how much does transit grow by?

Mr. JACKSON. It grows from $36.2 billion——

Senator SARBANES. Percentage.

Mr. JACKSON. The percentage, I would have to ask somebody to do——

Senator SARBANES. Ten percent? You gave me an $8 billion figure as against the 7.22 base. That would be 10 percent, would it not?

Mr. JACKSON. I am sorry, sir. I missed that question.

Senator SARBANES. You gave me an $8 billion figure against a 7.22 base. That would be a 10-percent increase, would it not?

Mr. JACKSON. Yes, sir.

Senator SARBANES. All right. You have an overall 19-percent increase, so highways is increased by how much?

Mr. JACKSON. Highways is increased by 23 percent over that period of time.

Senator SARBANES. Well, we have tried very hard to develop some equity or equitable parity between highways and transit, and, as I read your proposals here, you have completely thrown that in the wastepaper basket.

Mr. JACKSON. Senator, I don't think so, and I share very much your commitment to the transit investments that we need to make. In fact, the total money that we are committing over the period actually grows from TEA–21 to the new reauthorization proposal by some 26 percent. So we are putting more money in this investment. Then the point that I made to a previous question about the flex funds being used in the transit is a very important part to understand about how we are going to fund transit going forward.

When we first gave this flex funding authority in ISTEA, which Secretary Mineta was an author of, we didn't have a baseline and understand how to do it and how to use it. What we found, as I said, $1.2 billion is now flowing annually from highways to transit; $2 million went the other way. So flex funding becomes a significant tool to help States deal with these issues, and they are not represented in percentage increases that you and I were talking about.

Senator SARBANES. Well, now, wait, let me just——

Chairman NICKLES. Senator Sarbanes——

Senator SARBANES. I know my time is up, but let me just stop him on that right now. Have you eliminated the bus discretionary program, the one that makes capital investment grants for bus and bus facility improvements?

Mr. JACKSON. What we have done is combine a number of programs, I believe five programs combined down to two, and we put the bus money with some additional flexibility into the Formula Grants and Research category.

Senator SARBANES. Well, I mean, come on. You talk about flex money. It is not flex money. You are taking money that was there for particular purposes. You are eliminating the purposes, and then you say, we are providing additional funding. You are not providing additional funding.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Sarbanes, thank you very much.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. My apologies to you, Mr. Chairman, and to our witness. We also had an Energy hearing, which, of course, touches on this issue. Going last, I guess we are at the point in the hearing where almost everything has been said and almost everyone has said it. I just have one question that perhaps you can shed some light on how we have evolved on these transportation issues through this year, because it seems to me, Mr. Jackson, the Administration's position on transportation is sort of a movable feast. It just varies depending on the time, and I would like to see if I can make some sense out of the process.

The fiscal year 2003 budget started for Transportation at $23 billion. That was the President's budget proposal. Then it went to

$27.7 billion with respect to the supplemental. That is where it went next. As of last night, it went to $31.8 billion.

What I am really interested in is your explanation as to how this process works, because I want to see if I can take that information and figure out how to use it to get this account up. I think that transportation is, dollar for dollar, just about the best investment the country can make, and I would like to see if I could get your sense of how this process has worked over the year. Circumstances didn't change that dramatically, as far as I can tell, in terms of the transportation situation. But somehow it went through these three stages and went from $23 billion to $31.8 billion. If you will give me some information as to how you all went about making these judgments, I think then I may be able to divine a strategy that will help me get this account up that is so important for 2004. That is what my constituents want. They thought it was useful that I voted for the Gregg amendment to cut capital gains and joined Senator Nickles on estate taxes and the like. But what they think is really useful is transportation. That is what they think makes sense dollar for dollar in terms of a stimulus package, and I want to get this account up. Tell me how it went through these stages throughout 2003.

Mr. JACKSON. I will be happy to give you a concise history of that as best I can, and since you had an important role in this, I think you probably have a fairly good understanding on some of these elements yourself.

It is a very simple thing. We talked earlier about a working man and his paycheck, working for a company that has done very well and that individual is given an opportunity to have a bonus at the end that supplements the paycheck.

If you think of that example, which many working men and women have in the course of their budgeting for their families, year in and year out, there is a lesson for what happened here in the plan laid out by Congress for managing our investments in the highway program.

We had a projected baseline obligation limit for each year of the authorization. It was $27 billion. We also had this tool, RABA, that said if the revenues into the trust fund are not as large as we expect, we will spend less, we will cut our budget and we will live on less. So last year, the President simply took the law passed by Congress and said we promised ourselves as a Nation that if we had less into the trust fund, we would live on less. That is the number we began with. It was $4.4 billion less than the previous year's baseline target.

That budget proposal was immediately pronounced a difficulty that we should not impose upon ourselves, and the Administration, after some conversations with the Congress, agreed to put the $4.4 billion back into the pot, which is to say to fund this program at the level that the TEA–21 authorization limits promised. What we didn't agree to, until the omnibus bill got to the point of closure, was that we should put the additional, if you will, bonus payment that came from having a good economy in 2002 and make that part of the baseline in 2003.

What has happened here is that the Congress has come to expect that the bonus payment is part of our salary. It is not part of the baseline salary. It is a bonus payment that came from a good economy. We didn't have a good economy last year, yet we have just voted ourselves another $4 billion bonus.

I know the money is going to a good purpose. I certainly appreciate and understand that. But what we did was pass a law and say here is how we will discipline ourselves, and what we have now done is consider the bonus the entitlement. That is simply what happened.

At the end of the day, the Administration agreed that this was an investment that it was willing to make as part of the overall assessment of what we needed to do to deliver a set of appropriations bills.

Senator WYDEN. I am still mystified as to how we are going to do all this again in 2004.

Mr. JACKSON. It was very painful this year, so I am somewhat mystified myself.

Senator WYDEN. One can kid about it, I guess. My constituents think that this is tremendously important from an economic and a stimulus standpoint, and I want to be able to explain in something resembling English how these decisions are made. I think you are saying there was a good year in 2002, but we really did not think it was a good year in 2002. Eventually we decided there was a good year in 2002, so we will give you some more at the final calculation for 2003.

If that is what you are saying, and tell me if that is the case. I do not know where we end up in 2004, because this obviously has not been such a good year.

Mr. JACKSON. Well, I will try to go through this from the point of view of the budget mechanism of the RABA, and it is probably a longer conversation than can be sustained by the time allotted to me, but the RABA mechanism has two provisions that help us decide whether we can go up or should go down around the baseline that was passed. One part of it is a so-called look back, which considers the amount of money that actually came into the trust fund. That is the look back. Then it takes the Treasury forecast of what will happen in the year ahead—the look forward—and it adds that into the equation. So the combination of look forward and look back becomes a projection for RABA that allows us either to adjust upwards or downwards from the authorized level of the 6-year program. In most of TEA–21 we had a plus number. At the end we had a negative number. So that is the law and that is the way the law works.

What I would say to your constituents is that the President's budget overall imposes a 4 percent increase in discretionary programs and that we have proposed a 6 percent increase in the highway fund.

Senator WYDEN. Well, I am not going to belabor this. I guess the look back and the look forward seem to have gotten it up once, which sounds useful, but now it sort of looks like we are ignoring this exercise because some of us think that this ought to be a good stimulus, and we cannot yet get a bipartisan agreement on it. I hope that we can. I want to engage the Chairman just for a moment. I think the Chairman has been absolutely right in coming back to the importance again and again of the value of getting a bipartisan agreement on this issue. Certainly if we cannot get a bipartisan agreement on every account, there ought to be an effort to get a bipartisan agreement on some key accounts. If ever there was one that was a natural, this one is. I mean there is not a single person who comes up to any of us and says, "This ought to be a Democratic road and this ought to be a Republican road."

All they do is talk about potholes and traffic jams and the like, and I want to end this by saying I am very anxious to work with the Chairman and pick up on his message that we try to do as much of this in a bipartisan way as we possibly can, and if ever there was an account that would lend itself to that, I think this would be the natural.

Mr. Jackson has been patient—I was late—and put this into something resembling English, but we need a process to get to the higher number quickly, rather than this water torture exercise that we have gone through in 2003.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Wyden, thank you very much.

Just a couple very quick questions, Secretary Jackson.

Administration believes it ought to abide by the law?

Mr. JACKSON. Yes, sir.

Chairman NICKLES. Is not RABA part of the law?

Mr. JACKSON. Yes, sir.

Chairman NICKLES. So should we not be spending 23 billion in 1903 instead of 31?

Mr. JACKSON. That was our initial proposal, sir.

Chairman NICKLES. I am just—I think Congress passed RABA.

Mr. JACKSON. Yes, sir.

Chairman NICKLES. With the previous administration, I might mention.

Mr. JACKSON. Yes, sir.

Chairman NICKLES. But the idea of that was to get money out of the trust fund, and I guess maybe people never really thought the negative might happen.

Mr. JACKSON. Right. We had 3 years during the 6-year period where it was a plus, and we had 3 years of a down.

Chairman NICKLES. What I think we are seeing is that Congress has no intention of abiding by the down side.

Mr. JACKSON. That appears to be true.

Chairman NICKLES. We will take the up side, but the down side, Congress is going to kind of ignore the law, and I think put us on a course that is either going to—I started to say bankrupt the trust fund, but inevitably lead to either higher gasoline taxes, or we are going to have some contractors that are going to be severely disappointed.

I might mention, I will drive some of our people nuts, but I think the 80/20 ratio is a little high for highways. Now, Senator Sarbanes was not really trying to get you to say we should go 50/50 on highways. He was trying to make the distinction between mass transit and highways, but 80/20 encourages a whole lot of things, that if it was a more balanced ratio—and I have been looking at Federal tax versus State tax. I think you would have a more balance—right now everybody wants all the Federal money from highways because the Federal Government is paying 80 percent. You have a more balanced structure. Even if you moved it to some extent—and you might be looking at different ways to help us out of this quandary, because obviously the votes are going to be there for continuing at 31 billion plus. We may have to try and figure out a way to do this. Some people would like to say they want a tax increase, but that is not going to pass in my opinion. So we have to kind of figure out how we handle this in the future, and maybe some ratio change, maybe even gradually or something. I do not know. We will just have to be thinking about it, because I can easily see RABA has just been ignored. We might as well repeal it, just ignore it, because it was just an excuse to get more money, but they never want to go down. It is kind of—you are right, that bonus became base and nobody wants it cut. But I also read the law.

One other little section of the law. I believe we passed a law that said that Amtrak is going to be self sufficient by 1902. Is that not a law? Was that not part of the 1997 bill that we passed that was trying to send a signal to Amtrak, you are going to have to get off the Federal subsidy train?

Mr. JACKSON. Yes, sir, it was.

Chairman NICKLES. Is that still the law? Is it still on the books?

Mr. JACKSON. That is the law that would be replaced by the reauthorization, but Amtrak failed to hit that self-sufficiency target.

Chairman NICKLES. I understand we failed to—is Amtrak due for reauthorization?

Mr. JACKSON. This year, yes, sir.

Chairman NICKLES. This year. I hate to see very 5 years we keep coming back, well, yes, we are going to have to fix it, and also in the meantime, if I remember the subsidy for Amtrak back in 1997 was, what, 600 million?

Mr. JACKSON. Just 2 years ago it was $521 million in the Administration's budget.

Chairman NICKLES. 500 or 600 million. Now the bill that just passed was—500 or 600 million, and now it is 1.1 billion in the bill that just passed. Your proposal is 900 million, which is a significant increase over 2 years ago.

Mr. JACKSON. Yes, sir.

Chairman NICKLES. Still people are clamoring that they want it to be more. Would you do me a favor and give me a list? I noticed in your budget proposal you mentioned several routes that had significant subsidies per passenger, per trips?

Mr. JACKSON. Yes, sir.

Chairman NICKLES. Did you do that—I am assuming you have it for all the lines. Would you go ahead and give that to us for all the lines?

Mr. JACKSON. Yes, sir, I would.

Chairman NICKLES. Would you do the same thing for essential air service?

Mr. JACKSON. We can give you those numbers on essential air service, yes, sir.

Chairman NICKLES. I would appreciate it. I know you had some reforms scheduled for essential air service, and I believe you are working—I believe I heard you say to Senator Murray's request, that you are planning on doing a—or introducing or proposing an Amtrak reauthorization reform proposal as well?

Mr. JACKSON. Yes, sir.

Chairman NICKLES. I would encourage that. I think we need to pass it. We did not really get it done last time. I think we passed in 1997, “hope you get there, but we did not really give you any direction.” Maybe Congress this time can lend some seriousness to the proposal, try to make it happen, try to save what maybe is economically a viable spinoff to other areas, maybe encourage States and other areas, maybe give States flexibility to use some of the mass transit funds that they cannot utilize, us that for Amtrak or other public transportation.

But anyway, the list of—also you mentioned that you have 26 mass transit projects that are new starts.

Mr. JACKSON. In this proposal, yes, sir.

Chairman NICKLES. In this proposal. I believe you mentioned the new starts would total $1.5 billion, and that was just in the 1904 budget. Would you give us a list of those and what their projected total cost is?

Mr. JACKSON. Yes, sir. I believe we have a list of all the New Starts program in this Budget in Brief book that we have provided to your staff, but if there are any questions, we would be happy to answer the questions about those.

Chairman NICKLES. I apologize because I tried to review most of this material and I did not get that far.

Mr. JACKSON. You could not possibly keep up with all that flow of paper, sir.

Chairman NICKLES. But I am concerned about getting started. I happen to be one that compliments you on moving to 50/50. I am concerned about encouraging new starts and having people think this is the grand salvation for some areas, and starting on projects that frankly are economically not viable and they would not be starting them if it was not for the fact that they thought the Federal Government was going to be picking up 80 percent of the cost or more, and I think if you increase the percentage cost at risk from the local area, then they will be much more prudent with their own dollars than they would be with Federal dollars. I really do believe there is this idea, that whether you are talking about highway funds, you are talking about Medicaid funds, you name it, if it is coming from the Federal Government, it is free, and let’s leverage this to the hilt, and with minimal consequences if their contribution is that small.

So anyway, you are supplementing the subsidy, and also I believe Senator Cornyn was asking for information on relative subsidies compared to different transportation modes.

Additionally, the Highway Trust Fund, you mentioned trying to transfer or your proposal to transfer the 2.5 cents gasohol tax, which now goes to General Revenue, and I believe I heard you say that that would raise about $600 million per year, would be moved from General Revenue that it is presently going into General Revenue, and will be going into the Highway Trust Fund. Is that correct?

Mr. JACKSON. Yes, sir.

Chairman NICKLES. Part of your theory is on that, you are looking at gasoline taxes, a user fee.

Mr. JACKSON. Exactly.

Chairman NICKLES. So people that are using the roads should pay for the roads.

Mr. JACKSON. Exactly.

Chairman NICKLES. Does a gasohol car do as much damage on the road as a——

Mr. JACKSON. Yes, sir, there is no material difference.

Chairman NICKLES. How much additional fund would be going—how much additional money would be going into the trust fund if the Federal excise tax was the same on gasohol vehicles as it is on other gasoline vehicles?

Mr. JACKSON. I believe there is a delta of 5.3 cents between what is collected in the tax on gasohol presently, and what is collected presently for gasoline.

Chairman NICKLES. The volume of that times the number of gasohol gallons would be equal to how many dollars?

Mr. JACKSON. It would be—roughly, since it is $600 million for the 2.5 cents, call it $1.4 billion, something in that range, probably would be a seat of the pants guess there.

Chairman NICKLES. So if it is 1.4 plus the 600, if you had basically gasohol you would be close to $2 billion per year if gasohol vehicles paid the same gasoline taxes as other gasoline?

Mr. JACKSON. Yes, sir.

Chairman NICKLES. There is also a very large category of vehicles that do not pay Federal excise tax. Correct me if I am wrong. Vehicles by some tribes, Native Americans, some are exempt from State tax. Are they also exempt from Federal tax?

Mr. JACKSON. To be honest, I do not know the answer to that question, sir. I will be happy to get that for you.

Chairman NICKLES. I notice in my State there is a growing number of tribes that I believe are exempt from Federal excise tax. I would be interested in knowing that, so if you could do that.

Mr. JACKSON. I would be happy to provide you a list of any exemptions that are available under current law.

Chairman NICKLES. Also with the amounts it would raise if that exemption was not there.

Mr. JACKSON. Yes, sir.

Chairman NICKLES. I happen to look at roads as users should be paying for them, and I think that would make sense. Would you agree that possibly some State—right now part of the Federal excise tax on gasoline, part of that 2.86 cents per gallon is for mass transit?

Mr. JACKSON. Yes, sir.

Chairman NICKLES. Some States do not have mass transit, or they have limited mass transit. It is in the form of bus, maybe some light rail or some other alternatives.

Mr. JACKSON. Yes. I do not think I could find a State that does not have some meaningful mass transit and makes use of those. There is the ability to flex part of your mass transit formula funding into highways if you are not going to be able to use it for mass transit purposes. As I explained earlier, I believe in the year 2002 it was slightly over $2 million that flexed from——

Chairman NICKLES. 2 billion?

Mr. JACKSON. $2 million. It was $1.2 billion that went the other way, and it was a couple of million dollars that went that way. So that says that the States are actually using their formula for transit projects, and they are taking some of that highway money, a significant amount, $1.2 billion net through out the country, and putting it into transit investments.

Chairman NICKLES. I thought maybe you misspoke a little earlier. So you are saying that some States have taken as much 1.2 billion out of highway funds and used those for mass transit?

Mr. JACKSON. Exactly. All the States collectively spent that much in 2002.

Chairman NICKLES. Only a couple of million that actually went from transit to highways?

Mr. JACKSON. Exactly.

Chairman NICKLES. Maybe I am being parochial, but my recollection is, like a State like mine, we receive very little out of the transit funds, very little, de minimis, 10 percent of what we contribute, something like that. That is for bus in Oklahoma City and Tulsa. I worked some time ago to try to get some flexibility on some of that money to be used to subsidize Amtrak, which at that time we did not have in our State. So that was an effort that I made, which it is kind of a form. So we would be connected to this interstate system that we were not presently.

Mr. JACKSON. Yes.

Chairman NICKLES. We are presently on it. Do you think that makes sense? Should States be able to have some flexibility to be able to at least get some de minimis amount of the transit funds if they so desire for Amtrak?

Mr. JACKSON. I think that is something we should take a hard look at, and I would be happy to do that. We are, as a principle, in President Bush's proposals for transportation, trying to give States a maximum amount of flexibility to spend their money in the way that the States think is appropriate. So that would have to be something that we look at in our TEA–21 reauthorization and also think about it in the context of the Amtrak reauthorization.

Chairman NICKLES. I would appreciate it. Did I ask you for—I did ask you for a list of the Amtrak subsidies by route?

Mr. JACKSON. Yes, sir, by route. We can give you that, yes, sir.

Chairman NICKLES. So we can kind of figure out which ones are breaking even, which ones are not, which ones are subsidized, which ones are subsidized by their States.

Mr. JACKSON. Yes, sir.

Chairman NICKLES. I believe you mentioned Washington might be subsidizing or helping their State. We are in our State.

Mr. JACKSON. You are in your State, and California is in their State. There are a few States that do that in a systematic way, but there are only a few that provide that type of assistance.

Chairman NICKLES. I believe in your Amtrak proposal you are going to try and make that opportunity available for more States.

Mr. JACKSON. We are, yes, sir.

Chairman NICKLES. I understand. Secretary Jackson, I appreciate your cooperation before the Committee, and your endurance of maybe repetitive questions, but thank you very much.

Mr. JACKSON. Not a problem at all.

Chairman NICKLES. I appreciate your appearance and look forward to some of your answers to our questions. Thank you very much.

Mr. JACKSON. Thank you, Mr. Chairman. I appreciate your having me here.

Chairman NICKLES. The meeting is adjourned.

[Whereupon, at 4:18 p.m., the committee was adjourned.]

OPENING STATEMENT OF SENATOR JIM BUNNING

THANK YOU, MR. CHAIRMAN.

THIS IS AN IMPORTANT YEAR FOR TRANSPORTATION PROGRAMS. CONGRESS MUST REAUTHORIZE BOTH OUR HIGHWAY AND AIRPORT SYSTEMS. THERE IS ALSO THE LOOMING ISSUE OF AMTRAK REFORM. AND WE HAVE TO CONTINUE SECURING OUR BRIDGES, DAMS, PORTS, HIGHWAYS, AND AIRPORTS.

SEVERAL VERY IMPORTANT FEDERAL TRANSPORTATION PROJECTS IN MY STATE HAVE A LOT RIDING ON THE FISCAL YEAR 2004 BUDGET AS WELL.

WE HAVE THREE MAJOR BRIDGE PROJECTS, TWO NEW INTERSTATES, AND RUNWAY EXPANSION AT ONE OF THE NATION'S BUSIEST AIRPORTS ALL IN PROGRESS. WE ALSO HAVE MANY SMALLER ROADS AND AIRPORTS THAT NEED WORK, AND THE 2004 BUDGET IS CRITICAL TO ALL THOSE PROJECTS. I EXPECT THE DEPARTMENT OF TRANSPORTATION TO

WORK CLOSELY WITH MY OFFICE AND STATE IN MOVING THESE PROJECTS FORWARD.

I AM GLAD CONGRESS WILL VOTE TONIGHT OR TOMORROW TO RESTORE HIGHWAY FUNDING CUTS AND RAISE 2003 HIGHWAY SPENDING TO $31.8 BILLION. THAT IS AN ADDITIONAL $54.4 MILLION DOLLARS FOR KENTUCKY ROADS.

KENTUCKY IS NOT AT ALL UNIQUE. MANY OF MY COLLEAGUES HAVE SIMILAR TRANSPORTATION NEEDS IN THEIR STATE. EXPANDING ROADS AND RURAL AIRPORTS ARE SOME OF THE IMPORTANT ISSUES FOR MEMBERS. THEY EXIST IN ALL STATES AND ARE A GREAT TOOL FOR ECONOMIC GROWTH IN TODAY'S ECONOMY.

I LOOK FORWARD TO WORKING WITH THIS COMMITTEE AND THE DEPARTMENT OF TRANSPORTATION AS THE 2004 BUDGET PROCESS GEARS UP.

NOW I HAVE A FEW QUESTIONS FOR THE DEPARTMENT, AND A FEW MORE I WILL SUBMIT FOR THE RECORD.

Statement of Senator Jon S. Corzine
For the Senate Budget Committee Hearing on the
Department of Transportation Budget Proposals for the Fiscal Year 2004
February 13, 2003

Mr. Chairman, thank you for calling this hearing to discuss the Administration's proposed budget for the nation's transportation needs in the next fiscal year. I welcome Deputy Secretary Jackson today and look forward to his testimony.

Mr. Chairman, I have strong doubts that the budget that the Administration has proposed will be sufficient to meet the needs of our nation's transportation infrastructure. The challenges posed by increased traffic congestion, poor air quality, and an aging road, rail and bridge network require a strong level of financial commitment from the federal government. Unfortunately, I can not find that level of commitment in this proposal.

Mr. Chairman, the administration proposes a total level of highway funding for Fiscal Year 2004 of $29.3 billion. That is a decrease of $2.5 billion from the amounts appropriated in Fiscal Year 2002 and the amount that states should receive in Fiscal Year 2003, once Congress passes the Omnibus Spending Bill. If we allow that amount to stand, it will mean deep cuts in highway funding to states that are facing a deep fiscal crisis.

I am equally disturbed by the levels of funding for mass transit, Mr. Chairman. The Administration has proposed a FY 04 mass transit budget that is $7.2 billion. That is the same as the Administration's FY 03 budget request and the same as the FY 03 Omnibus Spending bill that is currently pending in House-Senate Conference. When you factor in the 2% rate of inflation that the Administration projects, it means that then the Administration is proposing a 2% cut for transit.

Finally, I am disturbed by the Administration's proposal for Amtrak funding. The Administration proposes $900 million for Amtrak for FY 04. Amtrak's President David Gunn has said that if he does not get $1.8 billion for FY 04, Amtrak will shut down operations. We narrowly averted a shutdown in the last Congress, Mr. Chairman. It disturbs me that we are again playing a game of chicken with the fate of Amtrak in the balance. My state relies on Amtrak more than any other state. If there is a shutdown, it will result in not only the ending of Amtrak's operations in New Jersey, but the ceasing of many of the operations of New Jersey transit trains that share the same rail network. 75% of all NJ Transit commuters – 82,000 people – would have to find another way to get to work.

I understand that the Administration's proposal is subject to change. Congress will establish different and hopefully higher highway and mass transit levels for each of the next six years. I look forward to this as a member of the Banking Committee, which will focus on mass transit. Thank you.

[The information follows:]

The following table lists actual FY 2002 Federal funding for the major Department of Transportation formula grant programs to State and local governments. Amtrak received $826 million in Federal funding over the same time period.

Mode	Program	FY 2002 ($ in thousands)
FAA	Airport Improvement Program (excluding State Block Grants)	$3,291,620
	Airport Improvement Program (State Block Grants)	$93,023
	Airport Improvement Program (Emergency Response Fund Only)	$174,960
	Total	$3,559,603
FHWA	Highway Planning and Construction	$31,883,390
	Miscellaneous Highway Projects	$400,407
	Appalachian Highway Development System (Trust Fund)	$59,872
	Appalachian Highway Development System (General Fund)	$99,387
	Total	$32,443,056
FTA	State Planning and Research	$8,496
	Fixed Guideway Modernization	$1,083,474
	Metropolitan Planning	$117,430
	Urbanized Area Formula	$4,269,907
	Rural Transportation Assistance	$5,753
	Other then Urbanized Areas Formula	$276,320
	Formula Grants for Special Needs of Elderly Individuals	$140,048
	Total	$5,901,428

[The information follows:]

The President's FY 2004 budget request includes a total of $65.9 million for Mexican Border activities. Included in this total are: (1) $42.9 million for the Federal Motor Carrier Safety Administration's (FMCSA) Motor Carrier Safety Operations & Programs account for Federal safety enforcement activities at the Mexican border to continue to increase safety compliance of commercial motor vehicles at border crossings, and; (2) $23 million for grants to states along the Mexican Border, which will support 3,000 border safety audits and 500,000 combined Federal/State border safety inspections.

In addition, the Federal Highway Administration (FHWA) includes $47 million in their FY 2004 request for the Mexican Border Infrastructure Program, the last portion of a three-year $162 million commitment to construct inspection facilities at Southern Border states.

[The information follows:]

Attached is a FRA analysis of the performance of Amtrak long-distance train routes based on data provided by Amtrak for FY 2001. Amtrak is currently improving its methodology for this analysis and a revised version of these tables will be available in a couple of weeks as part of Amtrak's FY 2003 funding requirements.

The first table—route analysis on an avoidable cost basis—reflects the costs (in dollars) of the individual trains that run on each route, including the cost of fuel, crew, and a percentage of Amtrak police, but no overhead costs.

The second table—route analysis on a fully allocated costs basis—reflects the costs (in dollars) of running the trains on each route, including all the avoidable costs listed above, plus a percentage of the costs of the shared facilities, such as operation and maintenance of stations along the route and maintenance facilities serving the route. It also includes a percentage allocation of Amtrak's overhead costs.

Analysis of Amtrak Long-Distance Route Performance

PRELIMINARY RESULTS

Based on FY 2001 Data

ROUTE ANALYSIS—AVOIDABLE COST BASIS	Avoidable (Deficit)	Avoidable (Deficit) per Passenger-Mile	Average Trip Length	Avoidable (Deficit) per Passenger-Trip	Operating Ratio (Avoidable Expense divided by Revenue)	Farebox Recovery (Revenue divided by Avoidable Expense)
Twilight Shoreliner	(453,729)	(0.007)	260	(1.87)	103%	97%
Lake Shore Ltd	(15,805,892)	(0.090)	598	(53.87)	152%	66%
Three Rivers	(8,804,003)	(0.121)	543	(65.60)	133%	75%
Capitol Ltd.	(7,910,641)	(0.095)	544	(51.53)	137%	73%
Cardinal	(7,924,166)	(0.277)	424	(117.29)	279%	36%
Silver Star	(8,489,947)	(0.049)	651	(31.89)	128%	78%
Silver Meteor	(4,368,907)	(0.026)	668	(17.32)	115%	87%
Silver Palm	(8,378,410)	(0.065)	593	(38.34)	130%	77%
Crescent	(9,596,930)	(0.064)	567	(36.26)	131%	76%
City of New Orleans	(8,915,291)	(0.096)	494	(47.61)	158%	63%
Texas Eagle	(16,132,166)	(0.122)	887	(108.58)	172%	58%
Coast Starlight	(11,996,542)	(0.046)	532	(24.30)	129%	77%
Empire Builder	(15,803,779)	(0.047)	845	(39.71)	130%	77%
California Zephyr	(19,734,626)	(0.063)	870	(54.63)	138%	72%
Southwest Chief	(14,593,014)	(0.048)	1146	(55.03)	122%	82%
Sunset Ltd	(18,741,858)	(0.148)	1152	(169.98)	206%	49%
Auto Train	15,142,409	0.082	861	70.78	72%	138%

PRELIMINARY RESULTS
Based on FY 2001 Data

ROUTE ANALYSIS—FULLY ALLOCATED COST BASIS	Fully Allocated (Deficit) (Exclusive of Depreciation)	Fully Allocated (Deficit) per Passenger-Mile	Average Trip Length	Fully Allocated (Deficit) per Passenger-Trip	Operating Ratio (Fully Allocated Expense divided by Revenue)	Farebox Recovery (Revenue divided by Fully Allocated Expense)
Twilight Shoreliner	(17,282,070)	(0.274)	260	(71.38)	206%	49%
Lake Shore Ltd	(43,851,836)	(0.250)	598	(149.46)	243%	41%
Three Rivers	(34,226,278)	(0.470)	543	(255.04)	229%	44%
Capitol Ltd.	(25,172,849)	(0.302)	544	(163.98)	217%	46%
Cardinal	(12,986,704)	(0.453)	424	(192.22)	393%	25%
Silver Star	(31,805,836)	(0.184)	651	(119.46)	203%	49%
Silver Meteor	(22,754,302)	(0.135)	668	(90.20)	180%	56%
Silver Palm	(30,432,332)	(0.235)	593	(139.25)	208%	48%
Crescent	(36,826,815)	(0.245)	567	(139.14)	220%	46%
City of New Orleans	(24,621,395)	(0.266)	494	(131.47)	261%	38%
Texas Eagle	(39,982,460)	(0.303)	887	(269.10)	279%	36%
Coast Starlight	(48,279,568)	(0.184)	532	(97.79)	217%	46%
Empire Builder	(48,568,744)	(0.144)	845	(122.04)	191%	52%
California Zephyr	(55,344,543)	(0.176)	870	(153.21)	207%	48%
Southwest Chief	(65,917,841)	(0.217)	1146	(248.59)	200%	50%
Sunset Ltd	(39,849,345)	(0.314)	1152	(361.41)	325%	31%
Auto Train	(13,849,128)	(0.075)	861	(64.73)	125%	80%

[The information follows:]

Subsidized EAS Communities as of February 1, 2003

States/ Communities	Estimated Mileage to Nearest Hub (S,M, or L) 1/	Average Daily Enplanements at EAS Point (YE 6/30/02)	Annual Subsidy Rates at Feb 1, 2003	Subsidy per Passenger	Total Passengers (YE 6/30/02)
ALABAMA					
Muscle Shoals	69	19.3	$1,284,408	$ 106.32	12,081
ARIZONA					
Page	280	11.1	$1,251,977	$ 180.61	6,932
Kingman	101	4.9	$541,502	$ 177.89	3,044
Prescott	102	12.4	$541,502	$ 69.79	7,759
Show Low	168	2/	$538,432	2/	2/
ARKANSAS					
El Dorado/Camden	108	4.2	$828,438	$ 315.00	2,630
Hot Springs	53	7.7	$989,018	$ 206.09	4,799
Jonesboro	79	6.9	$828,438	$ 192.57	4,302
Harrison	88	9.3	$989,018	$ 169.44	5,837
CALIFORNIA					
Merced	114	16.3	$844,479	$ 82.91	10,186
Crescent City	362	33.8	$333,717	$ 15.78	21,143
COLORADO					
Pueblo	43	6.4	$527,185	$ 131.50	4,009
Alamosa	162	12.2	$925,045	$ 121.00	7,645
Cortez	258	22.3	$403,311	$ 28.91	13,950
HAWAII					
Kamuela	39	8.5	$781,270	$ 146.50	5,333
Kalaupapa	None	7.4	$514,093	$ 111.69	4,603
Hana	32	17.5	$1,048,555	$ 95.90	10,934
ILLINOIS					
Decatur	120	27.9	$917,077	$ 52.44	17,487
Marion/Herrin	122	36.3	$794,031	$ 34.97	22,704

IOWA					
Fort Dodge	94	26.5	$1,088,354	$ 65.54	16,605
Burlington	163	29.0	$929,085	$ 51.23	18,136
Mason City	128	45.3	$1,088,354	$ 38.42	28,329
KANSAS					
Salina	93	12.6	1/	1/	7,872
Topeka	71	3.7	$621,872	$ 266.21	2,336
Dodge City	149	9.7	$1,159,886	$ 190.71	6,082
Liberal/Guymon	141	7.8	$824,776	$ 169.36	4,870
Great Bend	120	2.9	$298,799	$ 163.01	1,833
Hays	180	19.1	$1,330,824	$ 111.32	11,955
Garden City	201	23.1	$1,159,886	$ 80.07	14,485
KENTUCKY					
Owensboro	105	25.1	$888,863	$ 56.65	15,690
MAINE					
Augusta/Waterville	68	11.5	$1,205,855	$ 167.53	7,198
Rockland	80	20.3	$1,205,855	$ 94.99	12,695
Bar Harbor	157	36.4	$1,205,855	$ 52.98	22,762
Presque Isle	276	53.8	$1,480,512	$ 43.95	33,688
MICHIGAN					
Manistee	115	3.8	$485,545	$ 205.83	2,359
Ironwood/Ashland	218	5.7	$479,879	$ 135.18	3,550
Iron Mountain/Kingsford	101	24.0	$674,328	$ 44.81	15,050
MINNESOTA					
Thief River Falls	302	14.3	$707,017	$ 79.22	8,925
MISSISSIPPI					
Laurel/Hattiesburg	85	30.6	$1,056,991	$ 55.26	19,128
MISSOURI					
Kirksville	137	7.3	$732,363	$ 161.28	4,541
Fort Leonard Wood	130	27.5	$573,725	$ 33.37	17,192
Cape Girardeau	123	25.6	$430,925	$ 26.93	16,002

MONTANA					
Lewistown	558	2.3	$816,651	$ 566.73	1,441
Havre	674	3.0	$816,651	$ 428.24	1,907
Glendive	624	3.1	$816,651	$ 426.67	1,914
Miles City	529	3.2	$816,651	$ 403.09	2,026
Wolf Point	698	4.8	$816,651	$ 270.59	3,018
Glasgow	763	6.3	$816,651	$ 207.01	3,945
Sidney	653	6.7	$816,651	$ 194.63	4,196
NEBRASKA					
Alliance	256	2.1	$542,413	$ 415.01	1,307
McCook	271	5.5	$1,325,289	$ 382.04	3,469
Norfolk	109	3.5	$751,373	$ 342.16	2,196
Chadron	311	3.3	$542,413	$ 260.90	2,079
Kearney	181	18.4	$839,487	$ 73.01	11,498
North Platte	277	17.5	$751,373	$ 68.69	10,939
NEVADA					
Ely	237	2/	$976,533	2/	2/
NEW MEXICO					
Alamogordo/Holloman	91	4.3	$849,235	$ 316.52	2,683
Clovis	103	7.3	$1,118,197	$ 246.14	4,543
Silver City/Hurley/Deming	133	6.4	$935,667	$ 235.09	3,980
Carlsbad	139	12.5	1/	1/	7,836
Hobbs	88	5.7	1/	1/	3,556
NEW YORK					
Ogdensburg	123	6.3	$635,144	$ 161.74	3,927
Saranac Lake	63	7.8	$631,353	$ 129.93	4,859
Massena	118	8.0	$635,144	$ 126.65	5,015
Watertown	65	8.6	$635,144	$ 118.39	5,365
NORTH DAKOTA					
Dickinson	528	9.8	$1,540,089	$ 251.73	6,118
Devils Lake	405	7.4	$793,867	$ 171.35	4,633
Jamestown	332	7.5	$793,867	$ 168.33	4,716

OKLAHOMA						
Ponca City	81	9.9	$977,302	$	158.06	6,183
Enid	84	10.4	$977,302	$	150.70	6,485
PENNSYLVANIA						
Oil City/Franklin	86	13.0	$510,261	$	62.46	8,169
Altoona	108	35.8	$546,159	$	24.37	22,408
Johnstown	82	55.6	$301,417	$	8.66	34,825
PUERTO RICO						
Ponce	77	13.2	$337,551	$	40.84	8,265
SOUTH DAKOTA						
Brookings	206	2.7	$849,386	$	494.69	1,717
Huron	279	4.0	$394,585	$	157.64	2,503
Watertown	207	19.1	$1,871,825	$	156.27	11,978
Pierre	397	18.9	$318,861	$	26.93	11,839
TENNESSEE						
Jackson	85	25.3	$1,077,812	$	67.95	15,862
TEXAS						
Brownwood	147	6.2	$964,677	$	247.35	3,900
UTAH						
Moab	240	4.0	$971,444	$	384.58	2,526
Vernal	174	5.8	$1,102,967	$	304.94	3,617
Cedar City	178	28.9	$836,102	$	46.22	18,089
VERMONT						
Rutland	69	7.3	$1,205,855	$	263.17	4,582
VIRGINIA						
Staunton	113	34.9	$514,211	$	23.52	21,862
WASHINGTON						
Ephrata/Moses Lake	108	17.3	$1,132,911	$	104.78	10,812

WEST VIRGINIA					
Princeton/Bluefield	145	6.0	$1,033,847	$ 273.72	3,777
Beckley	181	8.1	$1,033,847	$ 202.75	5,099
WISCONSIN					
Oshkosh	49	6.6	$1,034,085	$ 248.46	4,162
WYOMING					
Worland	398	7.0	$353,345	$ 80.58	4,385
Rock Springs	184	25.7	$465,023	$ 28.86	16,115
Laramie	144	27.4	$297,633	$ 17.35	17,151

1/ Rate under negotiation.
2/ Service hiatus.

[The information follows:]

Fuel used in State and local government vehicles is exempt from Federal fuel taxes. Indian tribal governments are treated as State governments only if the fuel is used in an activity that involves the exercise of an essential tribal government function. Use in private local mass transit buses having a seating capacity of at least 20 adults (not including the driver) when the buses operate under contract with (or are subsidized by) a State or local government unit is exempt. Fuel used in the vehicles of non-profit educational organizations is also exempt.

Gasoline and gasohol are exempt from taxation if they are used: on a farm for farming purposes; off-highway for business purposes; in a boat engaged in commercial fishing; in an intercity or local bus; or in a school bus. Gasohol is partially exempt from the gasoline tax depending on the amount of ethanol included in the fuel.

Diesel fuel and kerosene are exempt from taxation if used other than as a fuel in the propulsion engine of a diesel-powered highway vehicle or diesel-powered train. Reduced rates apply to intercity buses and to trains.

The Department of the Treasury reports fuel tax exemptions by fuel type rather than by the basis for claiming the exemption. Total refunds and credits paid by the Highway Trust Fund during FY 2002 were $1,079 million distributed by fuel type as follows:

Gasoline	$323 million
Gasohol and gasoline to make gasohol	$41 million
Diesel	$711 million
Special fuel	$4 million

Senate Budget Committee Hearing
Department of Transportation FY2004 Budget
February 13, 2003
Questions for the Record from Senator Bunning

ESSENTIAL AIR SERVICE

Question. I am very concerned about changes to the Essential Air Service Program. Under the proposed budget, communities like Owensboro, Kentucky, will be required to pay to continue receiving EAS money. That just seems silly to me, since the EAS program is designed to help communities that have trouble supporting air service on their own. Now you propose to have them pay for something they cannot already afford. Why is the Department of Transportation proposing cuts to such an important program?

Answer. The Administration is proposing a fundamental change in the way that the government delivers transportation services to rural America. For too long, many communities --- there are a few exceptions --- have taken the air service for granted as an entitlement and done little or nothing to help make the service successful. Requiring a modest contribution should energize civic officials and business leaders at the local and state levels to consider innovative ways to make the most of their service, and to consider transportation alternatives. For the most isolated communities, the Department would continue to subsidize air service to the extent of 90 percent of the total subsidy required. The remaining communities would have to contribute 25 percent of the total subsidy required. In addition, the Department would work with the communities and state DOT's to procure charter service, single-engine, single-pilot service, regionalized service or ground transportation in cases where that seemed to be more responsive to their needs. In determining a community's standing in the program, the Department would incorporate the distance from small hub airports in addition to the distance to medium and large hubs. Some EAS communities are very close to small hubs but maintain their standing in the program because the nearby airport does not meet the medium-hub threshold.

OWENSBORO ESSENTIAL AIR SERVICE

Question. What am I supposed to tell the folks back in Owensboro about why they may lose their air service?

Answer. The idea of state/local involvement is certainly not a new idea. Billions of dollars of Federal Highway funds as well as Airport Improvement Program funds require some form of state/local match. In the case of Owensboro's EAS, civic officials and business leaders at the local and state levels will now have financial incentives to work hand-in-hand with the carrier to increase passenger usage and make the service successful. The EAS program basically pays a carrier for the gap between its expenses and revenues. We hope that as more and more passengers use the service and revenues rise, the carrier's subsidy need will go down over time, and, thus, the state/local match will likewise decrease.

The Department's experience with the Small Community Air Service Development Pilot Program, including those with the Kentucky communities, has demonstrated both the willingness of communities to contribute financially to their air service initiatives and their desire to participate more fully in shaping the form and success of those initiatives. The Small Community Air Service Development Pilot Program, authorized under AIR-21, is a grant-in-aid program designed to help small communities address air service and air fare issues. Four Kentucky communities, including Owensboro, submitted applications for grant awards last year. All but Lexington offered to contribute financially. Two communities, Somerset and Paducah, were awarded grants under the program. Somerset has actively pursued its goal to secure its first air service. The DOT grant of $95,000, together with the community's contribution of $18,000 (over 16% of the total cost of the project) has facilitated an in-depth feasibility study and plan to recruit an air carrier. Similarly, Paducah has committed to supporting 26% of the total project cost to upgrade service at its community and is actively pursuing its goal. Lexington did not offer a financial contribution. Owensboro offered a $70,000 contribution toward its proposed project (over 7% of the total project cost) and indicated that its proposed carrier would provide an additional 40% contribution.

ARMING COMMERCIAL PILOTS

Question. Last year I and many of my colleagues worked very hard to pass a bill arming commercial pilots. The last thing any of us want to think about is the possibility of having to shoot down one of our own airliners. The deadline for training the first pilot under this program is fast approaching. I have heard very little about implementation of this program, and what I have heard is not good.

What is the status of the implementation of this program and can I expect the final rules and regulations to implement the intent of Congress to train and arm pilots without imposing a burdensome application, training, and carrying process?

Answer. To meet the requirements of Title XIV of the Homeland Security bill, commonly referred to as the Arming Pilots Against Terrorism Act (APATA), the Under Secretary of Transportation for Security chartered a cross-organizational Task Force. The Task Force is comprised of individuals with extensive experience in law enforcement and security training, airborne law enforcement, Federal acquisition, personnel assessment, aviation policies and law, and stakeholder relations. The Task Force began its work on December 3, 2002, and addressed all requirements of APATA, as well as those necessary for the Transportation Security Administration (TSA) to establish, launch, and maintain a program. Under APATA, TSA had until February 25, 2003, to establish program requirements and begin the process for Federal Flight Deck Officer (FFDO) training and deputation.

TSA has met those requirements, and the continued development and successful implementation of APATA remains a top priority for TSA. Although APATA contained no funding, TSA committed significant resources to the development of this program. The goal was to train and to deputize pilots with limited authority to act as Federal law enforcement officers for the purpose of defending the flight deck of passenger aircraft against acts of criminal violence and air piracy.

TSA has defined basic program policy, and plans to conduct the 48-person prototype class at the Federal Law Enforcement Training Academy in mid-April. The 48 selectees and 7 alternates for the prototype class were notified via email on March 12 and will also receive a formal letter via postal mail. Individuals not chosen for the initial class will have the opportunity to be reconsidered for the program when it is fully implemented; the fact that they will not participate in the prototype has no bearing on their candidacy for subsequent classes. TSA expects to have pilots from the prototype class flying by early May.

NATIONAL HIGHWAY SYSTEM FUNDING

Question. A primary responsibility of the Federal Government should be to ensure that the interstate highways are adequately maintained. These are the highways that allow this Nation to be competitive in the global economy with other Nations whose factories are much more directly connected to ocean transportation. There are inadequate interstate maintenance funds for Kentucky to keep pace with the volume of truck traffic. There are many miles of our interstates that are just flat out coming apart for lack of maintenance money – not to mention inadequate funds for adding lanes.

In view of escalating truck weights and increased usage of the NHS for freight transport, the weight given commercial vehicles, and diesel fuel use as factors in the apportionment of interstate maintenance and national highway system funds, should the current system be reevaluated and what is the Department's position?

Answer. The Department agrees with you on the importance of maintaining the condition of our most important highways, and the need to recognize the impact of commercial vehicle travel in the apportionment formulas for Interstate Maintenance and National Highway System funds. Based on past experience, the formulas will be the focus of much debate. While the Administration's reauthorization proposal has not yet been released, the Department looks forward to working with the Congress as the reauthorization legislation proceeds.

NATIONAL HIGHWAY SYSTEM COST ALLOCATION

Question. What kind of cost-benefit analysis is being undertaken to ensure that heavy trucks are paying an equitable share of interstate and NHS costs?

Answer. The Federal Highway Administration periodically conducts cost allocation studies to evaluate the extent to which different vehicle classes pay federal user fees that are commensurate with their estimated share of federal highway program costs. The latest assessment was completed in 2000. A number of States do similar studies at the State level, comparing State highway use taxes paid by different vehicles with their share of cost responsibility for State highway programs. These studies typically do not quantify the costs and benefits of changing the tax structure to promote greater equity, but rather focus on the extent of the inequities in the current tax structure and options for improving equity.

INFRASTRUCTURE PROJECTS IN KENTUCKY

Question. Kentucky has three major bridge projects, two new interstates, and runway expansion at one of the Nation's busiest airports all in progress, in addition to many smaller roads and airports that need work. Cooperation between the Federal and State Departments of Transportation are critical for moving such projects forward in Kentucky and in other States. What cooperation can I expect from the Department of Transportation and what can my State do to ensure that our priorities are addressed in the coming year?

Answer. The Department stands ready to help you in any way we can. The Federal Aviation Administration (FAA) of the Department of Transportation (DOT) will continue considering Airport Improvement Program (AIP) funding for eligible high priority airport improvements in Kentucky and other States.

For example, FAA has responded to the requirement for runway expansion at the Cincinnati/Northern Kentucky International Airport in Covington, KY. During FY 2002, a Letter of Intent was signed approving nearly $132 million in AIP funding (including $100 million in discretionary funding) for a ten-year period from FY 2002 through FY 2011. The Letter of Intent is to construct Runway 17/35 and all support facilities (a third north/south parallel runway, 8,000 feet long) and to extend Runway 9/27. The FY 2003 scheduled payment for the Letter of Intent is $22.5 million, including $15 million in AIP discretionary funding.

FAA recognizes the importance of this new Kentucky runway to the national system and has included it in the Operational Evolution Plan. This Plan includes other major runways such as Atlanta, Miami, Denver, and Seattle. Integrated teams from several FAA offices are working with airport owners to help ensure these runways are commissioned in a timely manner.

In the case of highways, there are few discretionary resources available to the Department to address special needs. Nonetheless, the Department encourages the Kentucky Transportation Cabinet to continue to work closely in partnership with the Federal Highway Administration field office in Kentucky to advance projects.

The Brent Spence Bridge (I-75/I-71) over the Ohio River between Cincinnati, Ohio and Covington Kentucky, with a preliminary cost estimate of approximately $500 million, is one highway project in the State. Kentucky received $1.9 million in Interstate Maintenance Discretionary Funds in FY 2002, which will be used to develop an engineering feasibility study to look at a replacement structure. On February 26, 2003, a delegation from the Northern Kentucky Transportation Cabinet visited the Federal Highway Administration in Washington D.C. and briefed FHWA representatives on the condition of the existing bridge.

Two new bridges are also included in highway projects in the Louisville, Kentucky area. The first is a new bridge on I-65 in downtown Louisville and the second is the final link in the I-265 Outer Beltway Connector around Louisville. The Final Environmental Impact Statement will be signed very soon and the Record of Decision is targeted for signing in August 2003. Using 2003 dollars, the preliminary estimate for the entire project is $1.9 billion. Based upon inflation values, the project completion cost in 2020 will be $2.5 billion.

The Federal Highway Administration will continue to work in close cooperation with the Kentucky Transportation Cabinet on these projects.

Senate Budget Committee Hearing
Department of Transportation FY2004 Budget
February 13, 2003
Questions for the Record

LINKAGE BETWEEN HIGHWAY SPENDING AND JOB CREATION

Question. I believe we need to pursue policies that will help grow the economy. And I think we should evaluate federal budgetary decisions in terms of what spending increases or tax cuts can do to increase the amount the economy produces. So I want to get to the bottom of some mythology about highway spending.

1. A few years ago CBO did a study that examined to what extent different kinds of federal investments—spending on infrastructure, education, and R&D—contributed to increased economic growth. For highway spending, CBO concluded that (for most projects) there is little evidence to support the claim that such spending increases economic growth, and most such federal spending simply displaces state and local spending that would otherwise have to occur.

2. I expect that's why boosters of increased highway spending don't argue that it increases the economy. Instead, they claim that each additional $1 billion in highway spending creates a certain number of jobs, though no one seems to know how to justify such a claim. I seem to recall this started out in the 1980s when it was argued that an additional $1 billion in defense spending was worth 25,000. Now I've seen the Federal Highway Administration cited as a source for the claim that 42,000 jobs are created by $1 billion in highway spending. Some colleagues in the House have issued a stream of press releases suggesting that the same $1 billion is worth 48,000 jobs, then another time worth 57,000 jobs.

3. So Mr. Secretary, I'm having a hard time understanding how it costs less than $20,000 to create one additional highway job. Do you have any evidence that persuasively links federal

> highway spending to job creation, and, more importantly demonstrates that additional dollars spent on highways creates more jobs than other kinds of federal spending, say on homeland security, national defense, or the space program?

Answer: The Department of Transportation is not in a position to estimate the job creation capacity of investments in non-transportation programs and makes no claim as to the comparative benefits to the national economy of investments in highway infrastructure versus other sectors of the economy. However, competing uses for limited funding have caused public officials to scrutinize infrastructure spending closely and to evaluate the economic impacts of such spending.

The Nation's highway system is in a constant state of change. Every year new capacity is added to the network, and older facilities are replaced, reconstructed and repaired. The main reason for these expenditures is to maintain and improve the safe and efficient transportation system that is crucial to America's economic prosperity. Indeed, contrary to the findings of the CBO study, a substantial body of economic literature documents the positive contributions of highway infrastructure to private sector economic performance and productivity.

However, one type of economic benefit not typically considered in traditional project evaluation or broad-based economic studies is the employment impact of highway construction spending. FHWA is frequently asked to estimate the employment effects of Federal-aid construction expenditures. In collaboration with the Boston University (BU) Center for Transportation Studies, FHWA has developed a national level income and employment estimation model. This is an economic input-output model based on the Commerce Department's Benchmark Input-Output Accounts for the United States, modified to reflect labor and materials usage specific to different types of Federal-aid highway projects. The magnitude of income and employment can be expected to change with the level of Federal-aid highway construction spending and the amount of State and local matching funds. Also, the size and incidence of employment benefits will vary with Federal-aid program composition since different types of highway improvements have different labor and materials requirements.

For example, assume an across the board increase in Federal-aid highway construction spending of $1 billion combined with a state matching fund ratio of 20% (yielding total expenditures of $1.25 billion). Based on the results of the BU/FHWA model, this would be expected to generate:

- A first-round of employment benefits in the highway construction industry and materials supplying industries totaling 19,585 person-years. These jobs generate more than $570 million in worker incomes. An estimated 12,453 jobs occur in the highway construction sector and 7,132 jobs occur in equipment and materials supplying industries. In addition to the substantial numbers of Construction jobs, first-round employment impacts are particularly large in Transportation and Warehousing, Business and Professional Services, Stone and Clay Products, Petroleum Refining, Wholesale Trade, Fabricated Structural Metal Products, and Non-metallic Minerals Mining.

- A second-round of employment and income benefits that occur in other production sectors because of the additional demand for inputs needed to expand output in industries that supply highway construction materials. An additional 6,939 person-years of indirect employment generates incomes totaling $215 million. Indirect employment is distributed across a much wider array of industry sectors than first-round effects. In addition to employment gains in Business Services, Transportation and Warehousing, and Wholesale Trade, relatively large numbers of jobs also occur in Primary Iron and Steel Manufacturing, Finance Insurance and Real Estate, Automotive Repair Services, Machinery and Equipment, Crude Petroleum and Natural Gas, Chemicals, and Rubber Products.

- Overall, the dollar value of first and second-round goods and services produced by the additional highway construction spending is $2.93 billion. This implies a combined direct and indirect spending multiplier of 2.34.

- When direct and indirect employment incomes are spent, a third-round of employment and income benefits ripple through the economy. This is frequently termed "induced" employment and reflects producers' responses to an increase in consumer demand for all types of goods and services. The total number of person-years of employment generated by this additional spending is 21,052. Third round employment income is estimated at $528 million. The largest employment gains occur in the service sector, including Wholesale and Retail Trade, Business Services, Health Services, Restaurants and Amusements, Educational and Social Services, and Finance Insurance and Real Estate, and Communications. However, large induced employment effects are also observed in Textiles and Apparel, Construction, Agriculture Forestry and Fisheries, Food and Kindred Products, Printing and Publishing, Electric Equipment and Electronic Components, Motor Vehicles and Parts, Paper and Allied Products, and Rubber Products.

THE PRESIDENT'S FISCAL YEAR 2004 BUDGET PROPOSAL FOR MEDICARE AND MEDICAID

WEDNESDAY, FEBRUARY 26, 2003

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

The committee met, pursuant to notice, at 3:11 p.m., in room SD–608, Dirksen Senate Office Building, Hon. Don Nickles, (chairman of the committee) presiding.

Present: Senators Nickles, Gregg, Allard, Enzi, Crapo, Ensign, Cornyn, Conrad, Murray, Wyden, Stabenow, and Corzine.

Staff present: Hazen Marshall, staff director; and Megan Hauck, health policy director.

For the minority: Mary Ann Naylor, staff director; and Sue Nelson, deputy staff director.

OPENING STATEMENT OF CHAIRMAN DON NICKLES

Chairman NICKLES. The committee will come to order.

Today, the Budget Committee will hear testimony from the Secretary of the Department of Health and Human Services, Secretary Tommy Thompson. Prior to becoming Secretary of HHS, Tommy Thompson was Governor of the great State of Wisconsin for 14 years, and did a fantastic job as Governor. He was a pioneer in welfare reform, in Medicaid, in health care, in education. He really has been, and I say that not just bragging about a friend who happens to be testifying today as Secretary of HHS, but as a member who worked on welfare reform and health care issues, Governor Thompson was maybe the premier Governor who was leading the fight for real reform and real successful reform, I might mention, that saved a lot of people from the chains of welfare dependency and also changed the whole operation of welfare and saved money in the process. It is a real success story in this Senator's opinion. I was pleased to be a participant in, I believe, a very positive, evolutionary, significant reform.

The Secretary has proposed significant reforms in Medicare and Medicaid as well. We look forward to hearing from him on both of those issues today.

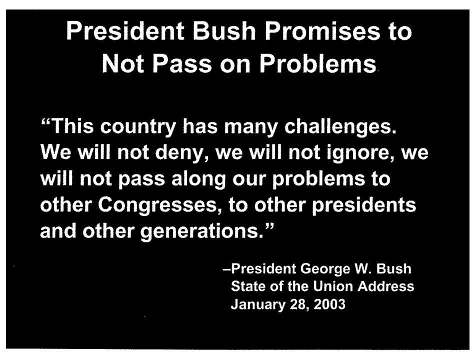
Before I make any further comments, I would call upon the ranking member, my friend Senator Kent Conrad.

OPENING STATEMENT OF SENATOR CONRAD

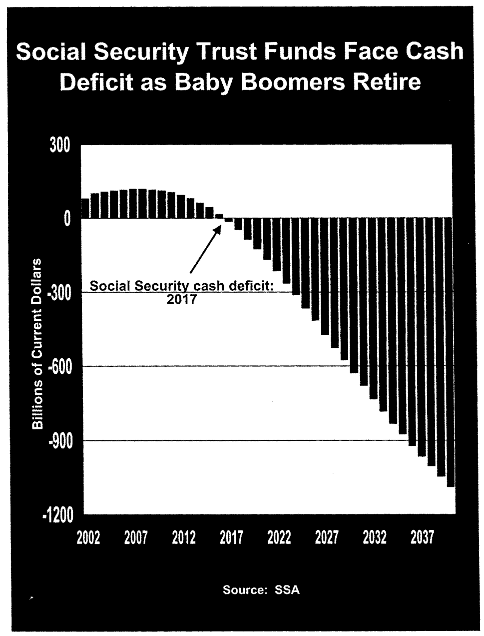
Senator CONRAD. Thank you, Mr. Chairman. I want to add my voice to yours in commending the Secretary. I always thought he was innovative and creative and focused on issues that really make a difference. As Governor, I very much appreciated the work he did on welfare reform and was glad we were able to move forward with that at the Federal level. I think we made dramatic improvements, and a lot of it was based on work that you did as Governor, and we want to recognize that.

I also have always felt as a Midwesterner a certain kinship and I have especially appreciated the sensitivity that you have shown on issues that relate to rural health care. We have a lot of problems out there, and you are acutely aware of them. Differential medicare reimbursement levels around the country create very serious problems for rural parts of our Nation.

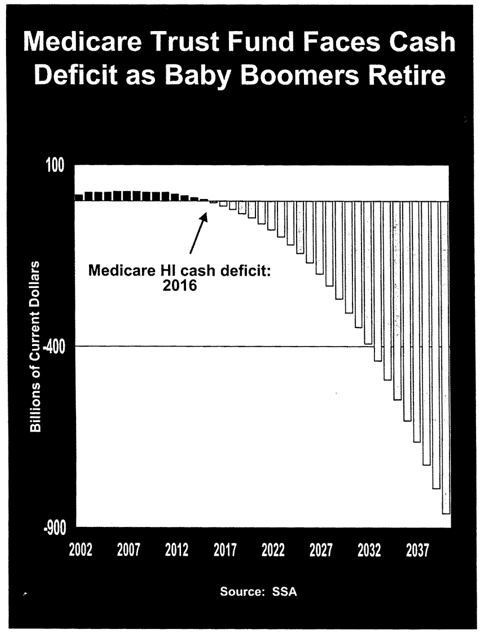
I have used the example many times that Mercy Hospital in Devil's Lake, North Dakota, gets half as much as Mercy Hospital in New York to deal with a heart attack; exactly the same illness but half as much money. Rural hospitals don't get rural discounts when they buy equipment, and they don't get any rural discounts when they have to pay salaries for the people that work in those institutions.



Today, in terms of an opening statement, Mr. Chairman, if you will permit, I want to point out the things that concern me deeply, because as I look ahead, this is what I see. These are projections from the Social Security Administration. They show that we are in the sweet spot now in terms of the Social Security Trust Fund. It is throwing off nearly $200 billion a year in surpluses, but we see that in 2017 it goes cash-negative. When it goes cash-negative, it does so in a big way. It is like falling off a cliff. We have got to prepare for that time.



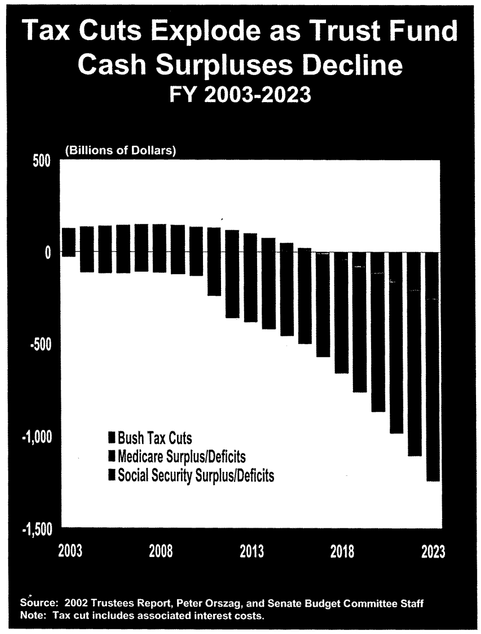
Let's go to the next chart that shows the same pattern with respect to Medicare. The Medicare Trust Fund is running cash surpluses that are much more modest than Social Security, but it goes cash-negative in 2016. Proportionally, it is an even more stark and more serious story in terms of the trajectory.



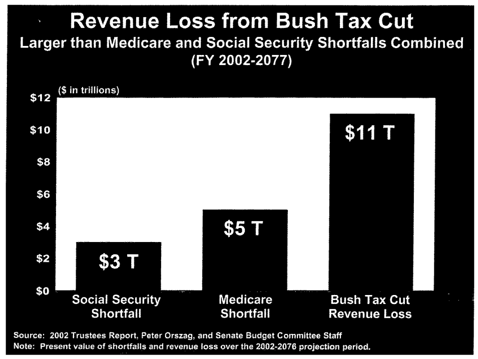
Let's go to the next chart. This one is really the most important because it puts all the information together with the President's proposed tax cuts. And this is why, I must confess, I don't comprehend what the President has proposed. It seems to me that it doesn't add up, and it has us headed over a cliff.

On this chart, to the tax cuts are in red, the Medicare surplus deficits are in blue, and the Social Security surplus deficits are in green. The Medicare and Social Security estimates are based on GAO's analysis. Frankly, I think they are somewhat conservative, but we are using their numbers.

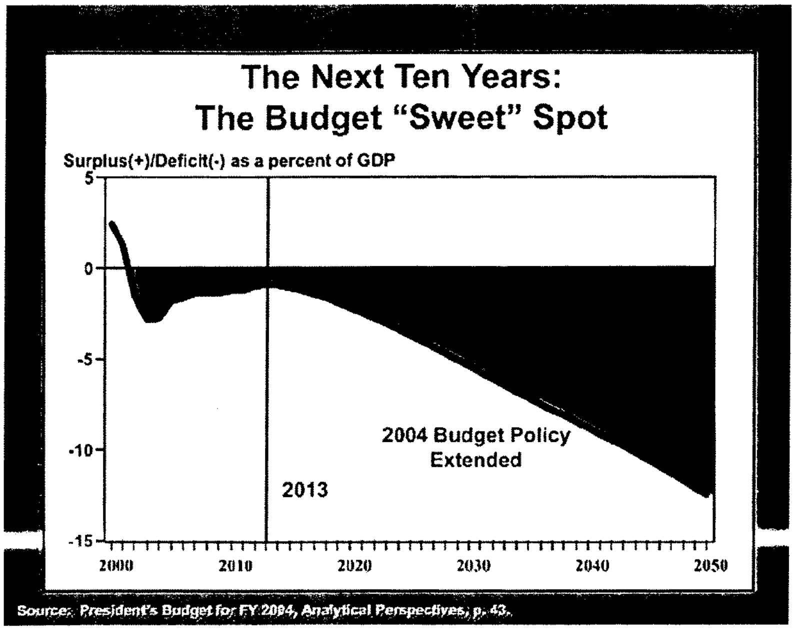
We prepared the tax cut estimates, because they are for an extended period of time going out to 2023. What one sees is that when the costs to the Federal Government in Social Security and Medicare explode, the cost of the tax cuts' explode. What we are left with is deficits of staggering proportion.

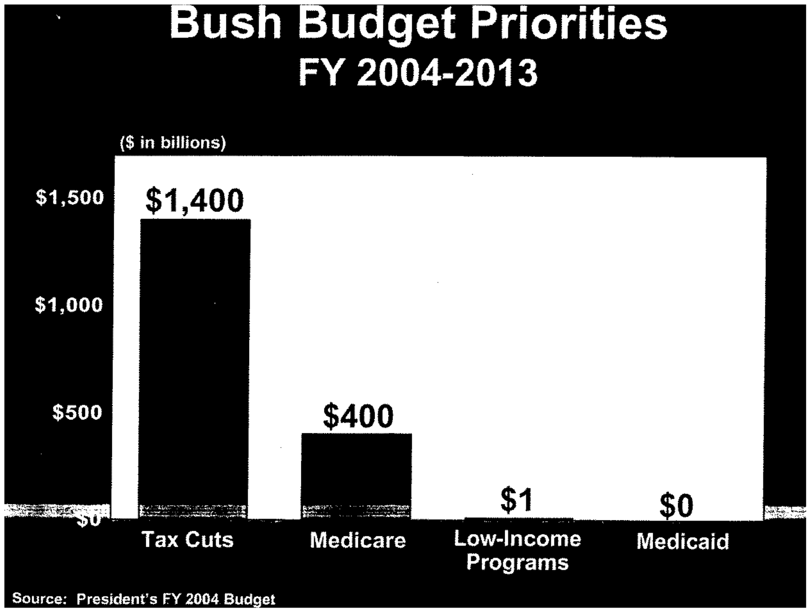


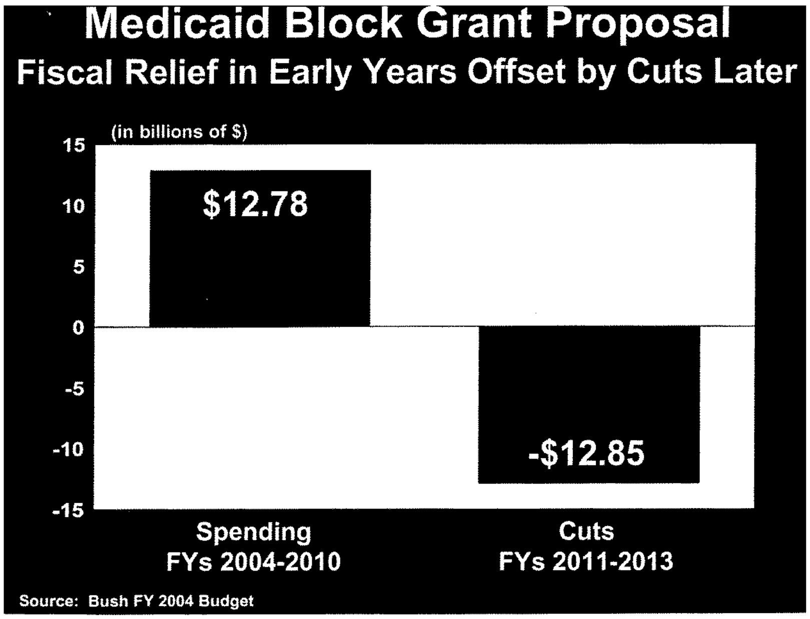
Let's go to the next chart. The revenue loss from the President's tax cut proposal is larger than Medicare and Social Security shortfalls combined. The Social Security shortfall—according to GAO—is $3.4 trillion and Medicare's shortfall is $5 trillion. The tax cut is larger than both combined, at $11 trillion over that period.



Again, I don't think we have a program in front of us that makes sense or adds up. The final chart is from the President's budget document, and it shows that we are in the sweet spot of the budget cycle now, with the trust funds throwing off substantial surpluses. But look what happens after 2013. Again, this is from the President's own budget document. After 2013, the deficits are totally unsustainable. This does not include war costs, the cost to fix the alternative minimum tax, or a number of other things that are likely to happen.


The Next Ten Years:
The Budget "Sweet" Spot
Surplus(+)/Deficit(-) as a percent of GDP
5
0
-5
-10
-15
2004 Budget Policy
Extended
2013
2000
2010
2020
2030
2040
2050
Source: President's Budget for FY 2004, Analytical Perspectives, p. 43.


Bush Budget Priorities
FY 2004-2013
($ in billions)
$1,500
$1,000
$500
$0
$1,400
$400
$1
$0
Tax Cuts
Medicare
Low-Income Programs
Medicaid
Source: President's FY 2004 Budget


Medicaid Block Grant Proposal
Fiscal Relief in Early Years Offset by Cuts Later
(in billions of $)
15
10
5
0
-5
-10
-15
$12.78
-$12.85
Spending
FYs 2004-2010
Cuts
FYs 2011-2013
Source: Bush FY 2004 Budget

So, Mr. Secretary, I think we are going down a budget path that makes no earthly sense to me, and that is what I want to talk about when we get to the questioning period.

Chairman NICKLES. Senator Conrad, thank you very much.

Mr. Secretary, Senator Conrad's chart showed a $5 trillion negative deficit, an unfunded liability in Medicare over the next 75 years. I think it is closer to $13.3 trillion, at least the figures—I am not sure what the differences are, but——

Senator CONRAD. If I might say, this is GAO's estimate of the shortfall counting the general fund transfer to Medicare. Your estimate excludes transfer, which is required by law.

Chairman NICKLES. I believe the unfunded liability on Medicare is $13.3 trillion. I believe the unfunded liability in Social Security is less than that. So we have significant problems, and I appreciate Senator Conrad's admonition. We need to do something about it.

I believe you have proposed some changes both in Medicare and Medicaid that would help alleviate the deficit. One of the fastest-growing accounts in Government today is Medicaid. You have a proposal to fix it. The States are all screaming. State governors have been coming into town to see us recently. Medicaid growth has compounded at really unsustainable rates. It needs to be changed, and you have a proposal to change it. We look forward to hearing from you.

Last year, Medicaid grew 14 percent. This is the Federal cost. The year before 9.7 percent; the year before that, 9.1 percent. Even the rate of growth been increasing every year. It is obviously not sustainable. It is not sustainable to the Federal Government or to the State governments. States have been saying, Federal Government, you pick up a greater share. It is not sustainable for the Federal Government either. So, you have some proposals to reform it. I compliment you for that. This may be the first significant reform in Medicaid in some time.

You also have some Medicare reforms to propose in an effort to save Medicare. I compliment you for those, and we look forward to hearing your explanations and suggestins regarding both of these very important, significant programs. I compliment you for your service in the past, and I look forward to working with you on these issues as well. Please present your statement.

STATEMENT OF HON. TOMMY G. THOMPSON, SECRETARY, UNITED STATES DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary THOMPSON. Good afternoon, Mr. Chairman. Thank you so very much for your kind words, and thank you for inviting me here.

Mr. Conrad, thank you as well for your kind words and for your charts and for your explanations.

Members of the committee, it is an honor for me to appear in front of you and thank you so very much for inviting me to testify this afternoon.

Mr. Chairman, I want to thank you for your continued leadership on so many issues that are vitally important to the American people. I have enjoyed our previous meetings, and I know that this whole committee wants what I want, which is for all Americans to be as healthy as they possibly can be.

In my first 2 years at the Department, we have made tremendous progress in our efforts to improve the health, the safety, and the well-being of the American people. We continue to make extraordinary progress in providing health care to lower-income Americans. Through waiver and State plan amendments which have been granted to States, we have expanded access to health coverage for more than 2.2 million individuals. We have expanded the range of benefits offered to 6.7 million other Americans.

To expand on our achievements, the President proposes outlays for HHS of $539 billion. That $539 billion represents an increase of $37 billion, or 7 percent, over last year's request, and an increase of more than $109 billion, or 25 percent, since 2001.

The discretionary part of the budget increase is $1.6 billion, or 2.6 percent, to $65 billion of budget authority. This would be $600 million, or 1.5 percent, higher than the enacted fiscal year 2003 appropriation bill. The $539 billion, ladies and gentlemen, is a big number, and I have a solemn responsibility as Secretary to make sure that every one of those dollars is put to good, effective use. I owe it to the people who pay the taxes, and I owe it to the people who consume the services.

One way to ensure these dollars are effective is to work with this committee and other committees to improve and strengthen our two largest health programs: Medicare and Medicaid. These are the two topics I would like to outline for you this afternoon.

As you well know, Mr. Chairman, Senator Conrad, our Nation's Medicare program needs to be strengthened and needs to be improved to fill in the gaps in current coverage. The President has proposed numerous principles for Medicare enhancements to ensure that we are providing our seniors with the best possible care. We have dedicated $400 billion over the next decade to achieve this ambitious goal, and we look forward to working closely with Members of Congress to develop and pass a responsible and effective Medicare bill this year.

The budget proposes a prescription drug benefit that would be available to all beneficiaries, would protect them against high drug expenditures, and would provide additional assistance through generous subsidies for low-income beneficiaries to ensure ready access to needed drugs.

Passing Medicare legislation will be a huge task, and improving Medicaid is also urgent. In fact, Medicaid is growing even more rapidly than Medicare. The Federal portion is $162 billion this year, and the program is growing about 9 percent a year. But State Medicaid programs are under tremendous financial pressure, and beneficiaries risk losing coverage. Two-thirds of the States currently have already made reductions or have reductions pending. The President has proposed a plan to preserve coverage, make Medicaid more efficient, and provide better health care delivery.

We must begin by addressing the immediate fiscal needs of the States. President Bush's plans would meet the 9-percent base growth in the program, and then would allow forward funding by $3.25 billion in the first year and $12.7 billion over 7 years. The forward funding would help people during the current economic conditions, and the flexibility would put the States in a better position to handle future economic downturns without having to cut people from Medicaid. They will have the flexibility to make adjustments to weather the storm.

I had a chance to discuss this proposal with many Governors, Republicans and Democrats, on Monday and throughout the weekend, and their reaction was very positive.

Let me be very clear about two things: first, State participation in a new program would be optional; second, mandatory populations would continue to receive all of their mandatory benefits. The Medicaid entitlement for mandatory populations would be unchanged. States will have much more flexibility in covering optional populations, which account for a large part of Medicaid spending. They will gain the ability to target special-needs populations such as those suffering from mental illness and AIDS and those who prefer home- and community-based coverage. If we do not improve Medicaid, 1 million Americans could lose coverage this year, and millions more next year. I look forward to working with Congress to make sure they keep it.

While I am here, I would like to mention one other item in our budget. President Bush recently announced a new initiative, Project Bio-Shield, that would help prepare this country for a bioterrorist attack. He would spend roughly $6 billion over 10 years on new counter measures. This proposal would speed up research, the approval of vaccines and treatments, and ensure a guaranteed funding source for their purchase, just the latest in our forward-looking efforts to protect the homeland.

Mr. Chairman, Americans have made many great discoveries over the years, and the discoveries that will endure the longest have expanded our understanding of nutrition and exercise, birth and aging, and how to prevent, treat, and cure disease, disability, and suffering. Our doctors have better knowledge and technology at their disposal than ever before. The rest of us also have access to a treasury of good advice about getting and staying healthy and energetic.

We have much more to discover, Mr. Chairman, and at the same time we also have the opportunity to put our recent discoveries into practice, to make sure America's Federal and State health programs and the entire medical industry reflect the best work of our researchers and the kindest impulses of our hearts. By working together, we have made great progress toward that goal. As the major proposals in the President's budget show, there is much more that we can do together.

The President has made improving our Nation's health and health care one of his highest priorities for the year, and by working together, we can make it one of our proudest achievements.

I look forward to all the work, and I know our discussion this morning will be able to get things rolling. So thank you, Mr. Chairman and members of this committee, for giving me this opportunity to come before you and answer your questions.

[The prepared statement of Secretary Thompson follows:]

STATEMENT

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON BUDGET

TOMMY G. THOMPSON

SECRETARY

DEPARTMENT OF HEALTH AND HUMAN SERVICES

FEBRUARY 26, 2003

Good morning Mr. Chairman, Sen. Conrad, and members of the committee. I am honored to be here today to present to you the President's FY 2004 budget for the Department of Health and Human Services (HHS). I am certain you will find that, viewed in its entirety, our budget will help improve the health and safety of our Nation.

The President's FY 2004 budget request continues to support the needs of the American people by strengthening and improving Medicare and Medicaid, enhancing Temporary Assistance for Needy Families (TANF) and Foster Care; strengthening the Child Support Enforcement Program; and furthering the reach of the President's New Freedom Initiative.

The $539 billion proposed by the President for HHS will enable the Department to continue its important work with our partners at the State and local levels and the newly created Department of Homeland Security. Working together, we will hold fast to our commitment to protect our Nation and ensure the health of all Americans. Many of our programs at HHS provide necessary services that contribute to the war on terrorism and provide us a more secure future. In this area, I am particularly focused on preparedness at the local level, ensuring the safety of food products, and research on and development of vaccines and other therapies to counter potential bioterrorist attacks.

Our proposal includes a $37 billion increase over the FY 2003 budget, or about 7.3 percent. The discretionary portion of the HHS budget totals $65 billion in budget authority, which is an increase of $1.6 billion, or about 2.6 percent. HHS' mandatory outlays total $475.9 billion in this budget proposal, an increase of $32.3 billion, or roughly 7.3 percent.

Your committee will set the framework for achieving many of the Administration's most important priorities. I am grateful for the close partnership we have enjoyed in the past, and I anticipate working hand-in-hand with you on an aggressive legislative agenda to advance the health and well being of millions of Americans.

Today, I am pleased to come before you to specifically discuss the President's proposals to strengthen and improve Medicare and to modernize the Medicaid program. A top priority for both the President and me continues to be strengthening and improving these vitally important programs that provide for the health care needs of many of our nation's seniors, low-income individuals and individuals with disabilities. We remain committed to delivering stronger, better Medicare and Medicaid programs to the Americans who rely on them. I look forward to working closely with this Committee and Congress to take meaningful action this year.

Strengthening and Improving Medicare

As we are all aware, our Nation's Medicare program needs to be strengthened and improved to fill the gaps in current coverage. We remain steadfastly committed to ensuring that America's seniors and individuals with disabilities can keep their current, traditional Medicare. The President has proposed numerous principles for Medicare enhancements to ensure that we are providing our seniors with the best possible care. The budget builds on those principles by dedicating $400 billion over ten years to strengthen and improve Medicare, including providing access to subsidized prescription drug coverage, better private options and better insurance protection through a modernized fee-for-service program.

Prescription Drug Coverage

Ensuring that Medicare beneficiaries have access to needed prescription drugs is a key priority for the Administration. This budget proposes a prescription drug benefit that would be available to all beneficiaries, protect them against high drug expenditures, and would provide additional assistance through generous subsidies for low-income beneficiaries to ensure ready access to needed drugs. The Administration's prescription drug plan would offer beneficiaries a choice of plans and would support the continuation of the coverage that many beneficiaries currently receive through employer-sponsored and other private health insurance.

Medicare Choices

Medicare+Choice was introduced to provide beneficiaries additional options for Medicare coverage. Over the past year, the Department has made significant strides in expanding beneficiaries' Medicare+Choice options by approving 33 new preferred provider organization through a demonstration. However, due to a variety of factors, in many parts of the country, few other new plans have entered the program.

More needs to be done to encourage plan participation. We believe that we should move away from administered pricing to set Medicare+Choice rates. The Administration believes that Medicare+Choice payments need to be linked to the actual cost of providing care. America's seniors and citizens with disabilities should have access to the same kind of reliable health care options others enjoy and that those choices should be provided through a market-based system in which private plans compete to provide coverage for beneficiaries. Those beneficiaries who select less costly options should be able to keep most of the savings. It is time we give our seniors and citizens with disabilities the choices they have been promised in Medicare.

Modernized Fee-for-Service

One of the basic tenets of our proposal to strengthen and improve Medicare is that seniors and Americans with disabilities deserve the same range of health care delivery choices federal employees enjoy. These choices should reflect the care and service innovations incorporated into today's best health insurance plans. A strengthened and improved Medicare program would rationalize cost-sharing for beneficiaries who need acute care. It would also eliminate cost sharing for preventive benefits and provide catastrophic coverage to protect beneficiaries against the high costs of treating serious illnesses.

Medicare Appeals

Our budget also includes $129 million for strengthening the Medicare appeals process. The adjudicative function currently performed by the Administrative Law Judges at the Social Security Administration would be transferred to the Centers for Medicare and Medicaid Services (CMS). In addition, the Administration proposes several legislative changes to the Medicare appeals process that would give CMS flexibility to improve the appeals system. These changes will enable CMS to respond to beneficiaries and provider appeals in an efficient and effective manner.

Strengthening and Improving Medicaid

State Health Care Partnership Allotments

Mr. Chairman, as you know, states are confronting serious challenges in running their Medicaid programs. It is crucial that we do something now to stabilize Medicaid programs so we do not allow millions of Americans to go without health care. Under current law, states have every right to eliminate coverage of optional populations and to drop optional benefits. They are doing so. In the past year, 38 states have reduced services or eligibility and most states are currently considering other benefit or eligibility cutbacks. We want to give states another option. It is our responsibility to work together so that States can get the help they need in managing their health care budgets, while preventing further service and benefit cuts and expanding coverage for low income Americans.

Building on the success of the State Children's Health Insurance Program (SCHIP) and the Health Insurance Flexibility and Accountability (HIFA) demonstrations in increasing coverage while providing flexibility and reducing the administrative burden on States, the Administration proposes optional State Health Care Partnership Allotments to help States preserve coverage. Under this proposal, States would have the option of electing to continue the current Medicaid program or to choose partnership allotments. The allotment option provides States an estimated $12.7 billion in extra funding over seven (7) years over the expected growth rate in the current Medicaid and SCHIP budgets. If a State elects the allotments, the federal portion of SCHIP and Medicaid funding would be combined and states would receive two individual allotments: one for long-term care and one for acute care. States would be required to maintain their current levels of spending on Medicaid and SCHIP, but at a lower rate of increase than the increase of the Federal share.

States electing a partnership allotment would have to continue providing current mandatory services for mandatory populations. For optional populations and optional services, the increased flexibility of these allotments will allow each State to innovatively tailor its provision of health benefit packages for its low-income residents. For example, States could provide premium assistance to help families buy employer-based insurance. States could create innovative service delivery models for special needs populations including persons with HIV/AIDS, the mentally ill, and persons with chronic conditions without having to apply for a waiver. Another important part of the new plan would permit States to encourage the use of home and community based care without needing a waiver, thereby preventing or delaying institutional care. Let me stress that this is an OPTION we are proposing for States.

New Freedom Initiative

One of the Administration's priorities is relying more on home and community based care, rather than institutional care, for the elderly and disabled. The New Freedom initiative represents part of the Administration's effort to make it easier for Americans with disabilities to be more fully integrated into their communities. Under this initiative, we are committed to promoting the use of at-home and community-based care as an alternative to nursing homes.

It has been shown time and again that home care combines cost effective benefits with increased independence and quality of life for recipients. Because of this, we have proposed that the FY 2004 budget support a five-year demonstration called "Money Follows the Individual" Rebalancing Demonstration, in which the Federal Government will fully reimburse States for one year of Medicaid home and community –based services for individuals who move from institutions into home and community-based care. After this initial year, States will be responsible for matching payments at their usual Medicaid matching rate. The Administration will invest $350 million in FY 2004, and $1.75 billion over 5 years on this important initiative to help seniors and disabled Americans live in the setting that best supports their needs.

The Administration again proposes four demonstration projects as part of the President's New Freedom Initiative. Each promotes home and community-based care as an alternative to institutionalization. Two of the demonstrations are to provide respite services to caregivers of disabled adults and severely disabled children. The third demonstration will offer home and community-based services for children currently residing in psychiatric facilities. The fourth demonstration will test methods to address shortages of community direct care workers.

Medicaid Coverage for Spouses of Disabled Individuals

The Budget proposes to give States the option to extend Medicaid coverage for spouses of disabled individuals who return to work and are themselves eligible for supplemental security benefits. Under current law, individuals with disabilities might be discouraged from returning to work because the income they earn could jeopardize their spouse's Medicaid eligibility. This proposal would extend to the spouse the same Medicaid coverage protection this Committee was instrumental in offering to the disabled worker.

Extension of the QI-1 Program

Under current law, Medicaid programs pay Medicare Part B Premiums for qualifying individuals (QI-1s), who are defined as Medicare beneficiaries with incomes of 120% to 135% of poverty and minimal assets. The Budget would continue this premium assistance for five years.

Transitional Medicaid Assistance (TMA)

TMA provides health coverage for former welfare recipients after they enter the workforce. TMA allows families to remain eligible for Medicaid for up to 12 months after they lose welfare related Medicaid eligibility due to earnings from work, and was scheduled to sunset in September 2002. TMA has been extended through June 30, 2003, through the appropriations process. This budget proposal would extend TMA for five more years, costing $400 million in FY2004, and $2.4 billion over five years. This program is an important factor in establishing independence for former welfare recipients by providing health care they could not otherwise afford.

We are also proposing modifications to TMA provisions to simplify it and make it work better with private insurance. These provisions include:

- States will be given the option to offer 12 months of continuous care to eligible participants.
- States may waive income-reporting requirements for beneficiaries.
- States that have Medicaid eligibility for children and families with incomes up to 185 percent of poverty may waive their TMA program requirements.
- States have the option of offering TMA recipients "Health Coupons" to purchase private health insurance instead of offering traditional Medicaid benefits.

State Children's Health Insurance Program (SCHIP)

As you know, SCHIP was set up with a funding mechanism that required States to spend their allotments within a three-year window after which any unused funds would be redistributed among States that had spent all of their allotted funds. These redistributed funds would be available for one additional year, after which any unused funds would be returned to the Treasury. An estimated $830 million in FY 2000 funds are expected to go back to the Treasury at the end of FY2003. The Administration proposes that States be permitted to spend redistributed FY2000 funds through the end of FY2004. Extending the availability of SCHIP allotments would allow states to continue coverage for children who are currently enrolled and continue expanding coverage through HIFA waivers.

Medicaid Drug Rebate

The current Medicaid Rebate methodology establishes rebates to State Medicaid agencies based in large part on the drug manufacturer's reported best price. The best price component of pharmaceutical rebates requires that the discounts that private sector purchasers are able to negotiate with pharmaceutical manufacturers also be given to Medicaid. It has been claimed that this provides a disincentive for drug manufacturers to give discounts to private sector purchasers. The Administration is interested in working with this Committee, the House Energy and Commerce Committee, and the Senate Finance Committee to explore policy options to address this issue.

Improving the Health, Well-being and Safety of our Nation

Mr. Chairman, the budget I bring before you today contains many different elements of a single proposal; what binds these fundamental elements together is the desire to improve the lives of the American people. All of our proposals, from building upon the successes of welfare reform to protecting the nation against bioterrorism; from increasing access to healthcare, to strengthening Medicare and Medicaid; all these proposals are put forward with the simple goal of ensuring a safe and healthy America. I know this is a goal we all share, and with your support, we are committed to achieving it.

Chairman NICKLES. Secretary Thompson, thank you very much. Let me just make a couple of comments and ask a few questions.

You mentioned Medicaid was growing at a rate of 9 percent. Last year, the Federal amount grew 14 percent.

Secretary THOMPSON. That is correct.

Chairman NICKLES. As a matter of fact, if you look all the way back to 1998, it was 5.9 percent, then 6.7, then 9.1, 9.7 in 2001, then 14 percent in 2002. That ramp really concerns me. If there was a 1-year spike and you expected it to come down but it has been getting bigger, then I am concerned that it may be bigger next year.

Now, you have proposed changing it, but part of that is because of congressional add-ons. Part of that is because we have changed some of the laws in the Finance Committee and others, a result of which is that we have given States great incentives to add people. I might mention that I believe about three-fourths of Medicaid spending is optional; in other words, you have mandatory Medicaid spending, but you also have optional Medicaid spending, optional on individuals, optional on income levels. Optional spending is where a lot of the explosion has been. I have been troubled by the fact under SCHIP we have a much greater Federal subsidy for higher income than Medicaid, and I think that needs to change. It bothers me to think that we would subsidize people with higher incomes more percentage-wise than we do people with lower incomes, and that is what we have done under SCHIP as an incentive for States, to cover some additional kids.

I believe your proposal, and maybe you can better explain it, would allow States to take the moneys that they are presently receiving under Medicaid, SCHIP as well as Medicaid mandatory and optional, and block that money together. Maybe "block" is not the right terminology—have flexibility on how they would cover those same people as far as benefits, and incentives, to participate. Is that correct?

Secretary THOMPSON. That is somewhat correct. If I could just take a few minutes to explain.

It is not a block grant because the mandatory population and the mandatory coverage for the mandatory population is not touched. We have a trend line that we have to decide each year somewhere around October, and it is based upon the cost accounting of the States. We project out a 10-year trend line, and for the next 10 years we project that the trend line is 9 percent.

Now, next year, if drugs keep going up, the trend line could be 10 percent, and that would change the trend line for the next 10 years, maybe at 10 percent. So we would project out for 10 years. That continues. That will continue. That will remain static.

The second part of it, however, allows for the one-third of the population which are the optional population—two-thirds of the population in Medicaid is mandatory; one-third is optional. Two-thirds of the services are optional and two-thirds of the costs in the budget are for the optional population and two-thirds of the options. So, we have allowed the States—we have taken the most successful parts of TANF, the most successful parts of SCHIP, and rolled it into Medicaid, so that States would have the discretion to be able to allow them to develop a better program in their Medicaid system and be able to get the Federal dollars to be able to allow for optional service without asking for waivers.

For example, the State of Utah had a Medicaid budget in which their health benefits were higher than the Governor and the State employees. They want to be able to reduce their health benefits in their Medicaid population to be able to buy into their State health plan, save money, and allow for more people to be covered. They couldn't do it under the Medicaid law because everything has to be uniform, so they will be able to change that and allow that to take place.

Your State, you have rural areas and you have urban areas. Under the Medicaid law, you have to have uniform and the same services from one part of the State to another. So if you add an optional population, you will then have to make sure of that in the urban area and in the rural area. So you may have an HMO that you want to put some people in. You can't do that unless you have HMOs in both to save money.

So, the States right now only have the capacity of continuing funding allowing the program to grow or be able to have the flexibility to define the kind of program they want for their particular State. That is the beauty of the changes. It is voluntary. So States could either accept it or not. Plus we would forward-fund $12.7 billion over 7 years. The first year would be $3.25 billion. We would ask the States to divide up the Medicaid pot into two blocks: one for acute care, which is not growing as rapidly, but the second one is long-term care and prevention, which is growing much faster.

What we would like to see happen is that States would be able to start addressing the long-term population, the elderly population. We would like to give them the flexibility for keeping more of their senior citizens in their homes, therefore lessening the cost and improving the quality of care. We are also putting more into prevention because that is where we are going to save the most dollars and improve the quality of health. They really don't have the capacity to do that under the existing law. This would allow them, if they want to go into it, to be able to do that.

Chairman NICKLES. Secretary Thompson, thank you.

I have additional questions on the upper payment limit which I think is a rip-off in the present system, one which is driving costs very high.

Secretary THOMPSON. That is true.

Chairman NICKLES. I want to try and stay on the 5-minute limit for myself and for all of our colleagues, so I will come back to you on that. By chance I don't get a second round, I will submit that question to you as well. I think upper payment has to be addressed, and the phase-out is very long, I think, under existing plans.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Let me follow-up if I can on where the Chairman started, because he talked about the increasing costs in Medicaid, which are sobering indeed. But it think it is very important to point out that it is not just in Medicaid that we have seen these escalating costs. In 1999 Medicaid increased by 5.8 percent, but private health insurance went up 5.5 percent. In 2000 they both went up 9 percent.

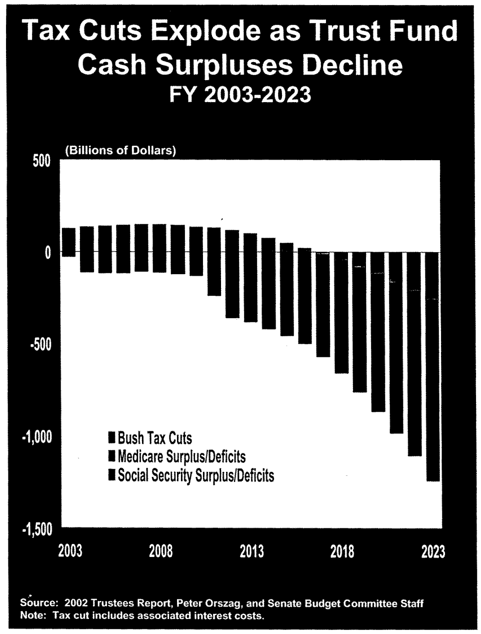
In 2001 private health insurance actually went up more (10.5 percent) and Medicaid went up 10.4 percent. So I think from that one could conclude Medicaid is doing a relatively good job, given the fact the program has a sicker and more disabled population than private insurers.

But what is happening here is that health care costs are driving everything up in a way that is clearly unsustainable. There is no way we can afford these double-digit increases in health care costs, either in Medicaid, Medicare, or in the private sector.

When I go home there is nothing brought to my attention more frequently by the business community and other institutions than what is happening to private insurance costs. We have without question, a serious challenge to the Medicaid system in terms of these costs, and Medicare as well. But more largely, this is a problem of health care costs in general in this country.

One other point I wanted to make is this. When we talk about optional groups, I look to what is happening in my home State. In North Dakota, medically needy individuals with catastrophic medical needs are allowed to spend down to meet income eligibility levels. The North Dakota income eligibility level for one person is $500 a month in net income. If they are above that, they are out. The leel for a family of two is $516. These are very, very low levels of income. What absolutely confounds me is how the President's tax cuts go together with the escalating costs in Medicare and Social Security.

You were a Governor. You had to balance budgets. You had to make tough decisions, and you did. I am sure you had a balanced budget requirement, or if you did not, you balanced the budget. This is the thing that absolutely strikes me as extraordinarily serious for the country. Again, the blue part of those bars is the Medicare surplus which turn to deficits. The green bars are Social Security. What started out as a surplus turns to deficits. The red is the effect of the President's tax cuts. What this chart shows us is at the very time the costs to the Federal Government explose because of the retirement of the baby boom generation, the costs of the President's tax cuts explode, driving us deeper and deeper into deficit.


Tax Cuts Explode as Trust Fund Cash Surpluses Decline
FY 2003-2023
(Billions of Dollars)
500
0
-500
-1,000
-1,500
2003
2008
2013
2018
2023
Bush Tax Cuts
Medicare Surplus/Deficits
Social Security Surplus/Deficits
Source: 2002 Trustees Report, Peter Orszag, and Senate Budget Committee Staff
Note: Tax cut includes associated interest costs.

Mr. Secretary, how do you explain this?

Secretary THOMPSON. Let me try to explain it this way. The health care costs in America are going up a lot because we spend, I think, money the wrong way. Our Medicare budget really drives medical care costs, and we spend 90 to 95 percent of our Medicare dollars on getting people well after they get sick, and less than 10 percent of the money on keeping people well in the first place. We spend $155 billion a year on tobacco-related illnesses in which 400,000 people die. We spend $117 billion a year on obesity, of which 300,000 people die. We spend $100 billion on diabetes, of which 200,000 die. 17 million Americans have diabetes today. 16 million more Americans are prediabetic. 90 million plus Americans have one or more chronic illnesses. That is driving up. If you add those three figures, that adds up to $384 billion a year on three diseases which can be prevented, and we only spend $269 billion on Medicare, and we spend $284 billion a year on Medicaid. So if you are going to have an impact on health care costs, we have to put more into prevention and we have to do something about changing human nature, about eating, exercising and not smoking. You will have the biggest impact of anything possible to lower the health care costs.

In regards to the taxes, I am not the President, but the President feels very passionate about the fact that he wants to make sure that the economy gets moving. He rightfully believes that the tax cuts will energize the economy and make up the deficits that you are talking about in the outer years by getting more people working and generating more money in the economy, and that is why the President is pushing the tax cuts.

Senator CONRAD. Let me just say though, the President's numbers do not show what you have just said. You have suggested that the tax cuts are going to energize the economy and lead to lower deficits. The President's own numbers show that the deficits explode under his spending and tax policy. This is his estimates of what happens.

I know my time is up, Mr. Chairman.

Secretary THOMPSON. All I can answer is that as I understand the way that matters are scored in Washington, nothing takes into consideration enhanced economic growth or development. So you do not have the positive side to a tax cut that goes into a chart like that.

Senator CONRAD. I just say to you, 2 years ago we had that same pitch made to us when we were told that we had 5.6 trillion in surpluses over the next 10 years. We passed the tax cut, and now we are $2 trillion under water, a $7.7 trillion reversal.

Chairman NICKLES. Thank you very much.

Senator ALLARD.

Senator ALLARD. Thank you, Mr. Chairman. I just would follow-up on that thought a little bit. That tax cut that happened 2 years ago, many economists said that we would have been worse off today if we had not had that in place, and even individuals who had not supported the tax cut 2 years ago had to admit that it did hold up the economy, buoy up the economy. In fact the editorial in the Washington Post, for example, in September, made that admission in their editorial page. So I do believe, and I think many economists do believe, that that tax cut that we had 2 years ago did hold up the economy. I think that your point is well made in that regard.

You are probably getting a lot of pressure now, if I may move on to another issue, from the States. I mean they are suffering a lot of shortfall as far as their revenues are concerned. I think they made the mistake in many cases, when the economy was doing well, they instituted a lot of programs. In the Medicaid program, I think about two-thirds of those programs in Medicaid are optional to the State, that about a third are mandated. I would guess that they are coming to you and asking for you to sustain some of those programs that they elected to go in partnership with as an optional program.

Would you share with me some of your thinking in regard to those issues as they bring them up to you?

Secretary THOMPSON. Absolutely, and thank you very much for the question. Senator, 38 States last year made reductions in their Medicaid budget. 32 plus of those States are going to make reductions to their Medicaid populations this year. The easy answer is just—and my fellow Governors came to me and said, "Just give us more Federal dollars and everything will be well." But to me, that does not solve the problem because the program is old, it is tired, it needs some streamlining and modernization, just anything else does. So instead of just putting more Federal dollars into it, I wanted to develop a system that is going to be more workable, more flexibility, more innovative, and so we have set up a program in which the States will get some additional money up front, $12.7 billion over 7 years, and $3–1/4 billion the first year. The trend line goes up at about 9 percent, which is adjusted each year in October and November, and we announce it in December and January.

If those States want to go into it on a voluntary basis, they would get for the first year an additional $3–1/4 billion and there would be about a 12 percent increase from the Federal dollars. The second thing we allow for them is that the States every year, in order to determine the State's share, they have to compute. They have a base thing. Usually it goes from 50 percent partnership from the Federal Government up to 77 percent in Mississippi. But each year, in order to readjust the base, States have to compute in September and October what their population increases are going to be, what their utilization is going to be, and what the medical indexing costs are going to be for their particular State. Those three factors are added on to their base budgets. So what we are saying, we are going to forego at the Federal level, if you come into the program on a voluntary basis, the fact that you will not have to increase your allotment based upon population or utilization, just the indexed cost of Medicaid, which would be a great savings for every State.

For that, for that good deal, we are asking the States to come in and divide up their population into two groups. The first one is acute care, which is not growing very rapidly, and the second one is long-term care and prevention, which is the most expensive and is the one that is growing the fastest. We are asking them to develop programs in how to manage that population better. We are going to set up a clearinghouse in the Department of Health and

Human Services of the best practices. We will be sending out suggestions for the States that are in this, how they could handle this population better and be able to prevent illnesses. Disease management would hold down a lot of cost, both for the Federal and State level. Managing individuals with diabetes, obesity, asthma and so on, and we could save money.

We would also encourage them to try and find ways in which they would keep their senior citizens in their own home using home health care, using other things, and giving them the flexibility to do that.

Then on top of that, we would allow them to have a 15 percent for administration for special needs population. For instance, if you have a State in which a factory closes down, we would allow them to be able to use the special needs population, or HIV/AIDS, or mental health, which they cannot get under this current medical assistance program, to be able to use money on a temporary basis for those categories of population to help them over this.

So it would be less money for the State. They would get an advance on their money, and they would have the responsibility for developing new, innovative programs to take care of their acute care and their long-term care, and developing more areas of prevention, as well as trying to keep their senior citizens in their homes.

Senator ALLARD. What kind of impact does that have on those programs that we are mandating down on the States? We do not give them an option. We just say there is a third. You got to take them.

Secretary THOMPSON. That is not being changed at all, Senator. The mandated programs, the mandatory populations will stay the same way under this existing law. That is why it is not a block grant. It continues to rise. A block grant is a flat leveled source of revenue, like the TANF bill. It is $16.8 billion a year for 5 years, $16.8 billion annually over 5 years. That is a block grant. This continues to grow. Plus it excludes the mandatory population with the mandatory options. They are maintained the same way under the new law as they will under the old law.

Senator ALLARD. Now, the first year is 3–1/4 billion?

Secretary THOMPSON. 3–1/4 billion.

Senator ALLARD. 12 percent increase?

Secretary THOMPSON. Pardon?

Senator ALLARD. Which is a 12 percent increase?

Secretary THOMPSON. Well, no. It is a 9 percent growth rate, and on top of that will be an additional 3–1/4 billion dollars. The total program is $284 billion. So about 2 percent. So 2 percent above the 9 percent.

Senator ALLARD. 11.

Secretary THOMPSON. About 11, 11 and 12 percent. So then in order to maintain——

Senator ALLARD. That is the first year, right?

Secretary THOMPSON. Yes, and the second——

Senator ALLARD. Is it constant?

Secretary THOMPSON. No. It is advanced funding of $12.7 billion over 7 years. There are different amounts.

Senator ALLARD. OK.

Secretary THOMPSON. It is about $2–1/2 billion. So if you draw on your piece of paper, you see a trend line like this going up here at 9 percent a year, and then for those States that would voluntarily go into it, they would be above the trend line out to year 2011, would by the seventh year. Then those States would fall below the trend line, would only be getting maybe 6 percent, 7 percent, instead of the 9 or 10 percent from the Federal Government, which would maintain and get their budget neutrality.

So the Federal Government would not spend any more money, but it would have the ability of allowing the States right now to get the money up front and be able to use the flexibility for developing a better program.

Senator ALLARD. When they get used to that amount of growth at the end of that curve, because you have it going up higher, then it drops down below.

Secretary THOMPSON. Below the trend line.

Senator ALLARD. Do you not kind of establish an appetite for the State and it is going to be very difficult to say no to, and they are going to expect that? Because you are talking about probably a whole different group of elected officials and policymakers?

Secretary THOMPSON. I am developing a program, Senator, that is going to work now. It is going to bring efficiency in. It is going to bring disease management in. It is going to bring in prevention and so on. There is no question—and being a Governor, I have to be absolutely candid with you—there is an insatiable desire at every level of Government to have somebody higher pay for the bill. But I developed a budget neutral program that is going to allow for flexibility and for new kinds of thinking in the Medicaid arena to really provide for States the opportunity to develop a better health care system.

Senator ALLARD. Mr. Chairman, I will wrap it up, but I just want to compliment Secretary Thompson. He is bringing in some new thinking, and thinking about reform. I think we need to do that. I appreciate it. I wanted to challenge you a little bit during the questioning.

Secretary THOMPSON. Please, challenge me.

Senator ALLARD. I appreciate that very much. We need people like you thinking out how we can make people more responsible on these programs.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Allard, thank you very much.

Senator WYDEN.

Senator WYDEN. Thank you, Mr. Chairman. I share my colleague's view. Tommy Thompson is one of the finest people in public life.

Mr. Secretary, as you know, my State is the poster child for Medicaid and health care flexibility. There is no State that has more waivers, for example. You could probably call me the Senator from the State of Waiver, because we basically waived out of the programs all together.

I am very troubled about the Administrations's Medicaid proposal, and I want to talk to you about how we might find some common ground here.

Flexibility is something the Governors are very much for. We have all been meeting with them. However, they are very worried about how this proposal ramps up on money and then reduces it. As the proposal is written, basically, the money is pulled away when the demographic tsunami hits in 2010 and 2011, when we have all these baby boomers. That is when the money would essentially go away. What I am hearing from the Governors, and I think my colleagues are hearing too, is that we might have a leave-no-child-behind experience, where it is not even 7 years before the money starts to disappear.

What could be done to guarantee to the Governors, to lock it in, that if they are part of this flexibility effort, that the money will actually be there 2, 4, 6 years out? That, at a minimum, is what I think we need to get to a compromise, because as I say, I think a lot of Governors are very troubled about the fact that the money is going to be gone just when that baby boomer tide rolls to shore.

Secretary THOMPSON. Let me answer it in three ways. The first way is the State of Oregon is not able to use its full SCHIP money. Your SCHIP money gets sent back to the Federal Government and redistributed to other States because you have a very progressive program that you passed before the SCHIP bill, same way as Washington. This would be ideal for you, because you would be able to use to SCHIP money to be able to help pay for low-income working parents, and that money would be able to be used in Oregon and Washington for that category of people, which would lessen the State's responsibility in that arena, and would be able to use your SCHIP money for a very good cause.

Second, the States would be able to lessen their payments because when you look at it, every September, those three factors that I mentioned—let me use it this way. It is about $122 billion a year which States are paying right now, and it is rising about 10 percent. So figure $12 billion a year increase that the States have to pay. The States, you have got to increase that payment. There is a base of $122 billion, and above that, they are going to have to pay an additional $12 billion next year into the Federal Government to meet their match. So we are reducing that match by two-thirds because we are waiving the requirement for the States to be able to have to increase their population base or their utilization, just their indexing. So it is wonderful deal for Oregon because they get their SCHIP money and they will have to pay less into the Federal Government to get their Federal dollars, which equates out to about a 1 percent increase on the Federal match for Oregon.

The third thing is, during this period of 7 years when the money has been increased and front-loaded, we are expecting them to develop programs that are going to help administer disease management, preventative care, and being able to keep seniors in their home. That is where we are dividing up the categories into long-term care and prevention and acute care, and it will allow for transferability of up to 10 percent of the money.

But those three reasons we think Oregon will be much better off, even when it goes below the line because there still will be an increase of about 6 or 7 percent each year in the out years, years 8, 9 and 10.

Senator WYDEN. Mr. Secretary, you say little that I disagree with, but it does not respond to the question that I asked, which is what can be done to lock it in, to guarantee it? That is what the resistance is all about. The flexibility you are talking about, we are for, and frankly, I can figure out some ways with you to do it as well. We could pass a law to just let people roll over their SCHIP money for example and do exactly the same thing. I am on board for the flexibility. What I am troubled about, and what your three points did not address is that if we do not have a guarantee, if we do not lock this in so that the additional funds accompanies the flexibility, I think we are going to find it very hard to move forward with what could be an extraordinarily helpful initiative. As I say, I could not be more supportive of the flexibility, the waivers. Your demonstration projects on the insued make sense. Frankly, the only quarrel I really have with you is, unlike Orrin Hatch and I, we actually have a bill, we have introduced a bill that has got the AFL-CIO and the Chamber of Commerce on it.

Secretary THOMPSON. I like your bill.

Senator WYDEN. We are still looking for your concepts to be translated into a bill. I know that is going to come. But if you can figure out a way, working with—and I think I reflect the views of a number of my colleagues and Democrat Governors, if you can figure out a way to guarantee these dollars are going to be there, I think we can do business on this flexibility issue, and do something to make a huge difference for scores of low income people.

Secretary THOMPSON. First off, the mandatory population is open ended, so that money is always there. The same way as the existing law is. The only thing is, is that on the optional population, in order to drive efficiencies, you have to make sure that the States are willing to make some changes. If you do not have that reduction in the years 8, 9 and 10, which is not a reduction from what they are getting or from the previous year, they will always go up. It is just that I do not see how you are going to make the States make changes to improve in prevention and treatment. I will be more than happy to work with you. I thank you for your ideas, and I will be looking forward to them, but that is my concern.

Senator WYDEN. I think you do have good ideas, but without the accountability, without the assurance on the part of the States, I think given the precarious financial straits of these States, a lot of them are going to be reluctant to do it. That will be too bad, because I think there is an opportunity here to do something effective.

One last question if I might, Mr. Chairman? I think I am probably on my time limit.

Mr. Secretary, on the Medicare program, one of the things that is exasperating our part of the world, and I know Senator Murray is concerned about this as well, is Medicare essentially penalizes people for holding costs down. What we need to do again to get ready for 2010 and 2011 is to send a message that, look, if you are going to be innovative, if you are going to come up with ways to stretch your dollars, and the like, that the Federal Government will send a message that we are not going to stick it to you. What happens now is our providers get penalized for being efficient with health care dollars. I mean why come up with anything innovative?

Why not just continue bumbling on through with clunky volume-driven services and rewarding people for being inefficient. What can we do in that area?

Secretary THOMPSON. Senator, we can do a lot, and you are absolutely correct. The problem is the Federal Government moves way too slow for me and for you and for most people, but that is the nature of the vehicle. In rural areas we have put in a rural health task force to look at this, and we have got a rural open door program which involves monthly toll free telephone conferences for interested parties to call in and get advice on how they can make changes for the better. We have a Sole Community Hospital Initiative that we started administratively last July. It changes its inpatient hospital payment regulation to allow more isolated hospitals to benefit from higher Medicaid payments which they did not know about that we allow. We have started an inpatient rehabilitation facility, incorporates a special adjustment for rural providers to account for the fact that the data showed it is more costly to provide rehabilitation service. We have a physician assistant ownership of rural health clinics, which they could not under the current law. We allowed that to be changed. We have a pass-through payment for the nurse anesthetist services which was not possible before. We have got a phase down of certain graduate medical education and costs from wage index calculation which helps rural areas, and helps Oregon, Washington, and Wisconsin and Oklahoma, and we have done that administratively. We have also allowed for staffing flexibility for certain critical access hospitals that rural areas desperately needed. Those are just some of the things we have done administratively.

Finally, our actuaries wanted us to raise the wage portion of the reimbursement formula from 71 percent to 72 percent, and we said that—which would have been a reduction in payments to rural hospitals. We said no, or I said no, and it stayed at 71 percent. I think it would be great, Senator Wyden, if we could set up a committee of individuals that really want to look at the overall Medicare system and try and find ways in order to improve it. I would love to be able to be part of that. I have several suggestions and ideas, and I would need somebody like you, Orrin Hatch, and Don Nickles, and anybody that wants to work on it, really wants to come in and roll up their sleeves. We could make some great progress in this are, and I am willing to do the heavy lifting to give you the ideas if you could just tell me what we can get passed.

Senator WYDEN. You always have been.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Wyden, Thank you very much.

Mr. Secretary, we will give you that chance this year.

Secretary THOMPSON. Thank you.

Chairman NICKLES. I am serious about that.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

Mr. Chairman, I have a statement that I would like to have included in the record.

Chairman NICKLES. It will be so included.

[The prepared statement of Senator Enzi follows:]

Brief Statement
February 26, 2003

Thank you, Mr. Chairman.

Also, thank you Secretary Thompson for joining us today. I understand you've already testified before the House Budget Committee, and I thank you for sharing your views with us this afternoon.

First, let me start by saying I'm encouraged by most of what I've heard about President Bush's plans to strengthen Medicare. Adding a prescription drug benefit for seniors who need help paying for their medicines is a great step forward for Medicare, as is developing an improved benefit for preventive services.

If Congress provides these expanded benefits in the context of a comprehensive modernization of Medicare, we will improve Medicare for today's seniors while safeguarding the program for the future.

The fact that Congress has to pass a law to add a prescription drug benefit is part of the problem with the Medicare system. Medicare is not flexible enough to self-adjust and adapt to the complex and constantly changing nature of health care delivery. Prescription drugs play a much greater role in treating disease today than they did when Medicare was created nearly four decades ago - but unlike private health plans, Medicare has not changed with the times.

I agree that we need to update the Medicare benefit package and enable the program's offerings to advance along with advances in healthcare practice. At the same time, we need to act to preserve Medicare for future generations. Already, 30 percent of Medicare funding comes from general revenues - and projected expenditures are expected to exceed projected tax and premium revenues after 2015. We need to act now before a Medicare crisis is upon us.

As a businessman, I am naturally predisposed to market-oriented solutions - but I recognize that the healthcare marketplace is not the most rational of markets.

I also recognize that Medicare was established in the first place to provide healthcare security to a group of Americans who didn't have many options in the private health-insurance marketplace. It's clear to me that the particular healthcare needs of the elderly who live in rural and frontier areas cannot be addressed with market incentives alone.

I am concerned about plans to modernize Medicare that would be predicated on expanding the role of managed-care organizations and other private health plans. Already, HMOs are complaining that their reimbursement is too low, and they have been dropping out of Medicare in droves.

Only 2.2 percent of Wyoming's population is enrolled in HMOs anyway, so it should be no surprise that there are no Medicare HMOs operating in Wyoming. If the best way for a Medicare beneficiary to get a prescription drug benefit is to enroll in a managed-care plan, then the senior citizens of Wyoming are not going to have meaningful access.

I know President Bush understands that Medicare beneficiaries in rural and frontier areas deserve equitable access to a new Medicare drug benefit. I hope Secretary Thompson can assure us that the President's plan to strength Medicare and add a prescription drug benefit will take into account the unique nature and needs of people on the frontier.

Senator ENZI. Mr. Secretary, we appreciate your being here, and I share your interest in creating more health care choices for the Medicare beneficiaries.

I am very concerned about the rural programs. You just mentioned some a moment ago, but in the rural areas, we do not have any real competition between health plans, and I would like to know how the President's plan to strengthen Medicare health plan competition would work in rural and frontier areas. We get a little bit beyond rural, actually.

Secretary THOMPSON. Senator Enzi, I cannot give you the details of the Medicare plan as of yet. We are very close to making the decisions, but the decisions have not been finally made. In fact, I have another briefing session with the President at the end of this week. We are very close, it is very imminent, and I would like to be able to hold my answer to your question until the final details are made so that I can give you all the correct information. I would hate to mislead you in any way, because I pretty much know where it is going, but I want to be absolutely certain before I give you an answer.

I can tell you that it would be based upon the Federal Employees Health Benefit Plan, FEHBP. Just like in your State, your foresters, law enforcement officials, your civil service and social service workers are able to have several different choices under the Federal Employees Health Benefit Plan, and that is the model that we are looking at.

Senator ENZI. So you are assuring me that there will be some rural and frontier components to it, then.

Secretary THOMPSON. That is correct, Senator.

Senator ENZI. I appreciate that.

Secretary THOMPSON. There will be some other changes, too.

Senator ENZI. I appreciate the emphasis that you are placing on preventive.

Secretary THOMPSON. Thank you.

Senator ENZI. We think there are some great strides that can be made there. Now, of all the times that I have talked to people about how much their program will save, I have never seen anybody come back with the numbers that show that it did after we implemented whatever it was. So I hope that we will have some of those numbers with it, too.

But what I am wondering about is that right now, two-thirds of the seniors can receive, say, the flu vaccine, and Medicare covers it. That is, all of them could receive it, but only two-thirds of them take advantage of the program at the present time.

Does the President's Medicare plan consider how to increase the utilization of that? If we are going to have the prevention, will they take advantage of the prevention?

Secretary THOMPSON. The President is very passionate about prevention, as I am. I cannot say at this time what is going to be in there on prevention, but I can certainly tell you what we are trying to do in the Department on prevention, because we are doing a tremendous amount, and I would love to enlist your help and be able to do more.

Senator ENZI. I am just concerned about that utilization and figuring out how to market it so that we can—if we put the prevention out there and people do not use it——

Secretary THOMPSON. We should require every Medicare recipient before they go into Medicare to have a physical, to be able to be examined, to be able to determine benchmarks, the condition. We would save millions if not billions of dollars on preventive care if we would just do that—if we set up programs requiring people with diabetes to walk 30 minutes a day, lose 10 to 15 pounds—you can reduce the instance of diabetes by 60 percent. We have just done an exhaustive study out at NIH. We have a program of $100 million that we are requesting in this budget, Senator, in which we would like to set up healthy cities, at least 10 healthy cities across America, that would have to reduce the incidence of obesity, asthma, and diabetes in their city in order to quality. They would be designated a "healthy city." We think that a lot of cities are going to be vying for that; we think it is great.

We have a $125 million program for "tweeners," those kids between the ages of 9 an 13, to become physically active, to pick a verb—walk, run, jump, ski, dance, whatever the case—and we are putting out a lot of information on this.

We are going out into the minority communities where diabetes and obesity are very high, and we are trying to figure out ways in which we can address those particular issues. That is where we are going to save the dollars, and that is going to improve the quality of health of so many Americans.

Senator ENZI. I certainly appreciate your enthusiasm on it. I saw that enthusiasm when you were starting the welfare reform movement in the country, and I have a lot of confidence that that is going to happen now in this program as well.

I know that I am out of time. I do have a couple more questions; I will submit those. I know that you have some very able staff who can help in answering these questions, too, because she came from my office.

Secretary THOMPSON. Senator, I always say I have the best people in the Federal Government working for me, and I stand by that statement, sir.

Senator ENZI. Thank you.

Secretary THOMPSON. Thank you very much for allowing us to hire her.

Chairman NICKLES. I would vouch for that, Senator Enzi, absolutely.

Chairman NICKLES. Senator Murray.

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

Thank you, Mr. Secretary, for being here today. Just to followup on one of Senator Wyden's questions, you mentioned the SCHIP allocation and some of the funding challenges that we face in Oregon and Washington and other State returning dollars. A question I have on the Medicaid dollars that you are putting out there and how you are going to allocate it—are you going to base that on expenditures or allocation, because that is really important to our States. If you are going to base it on expenditures, that will be very different than if you base your formula on allocation.

Have you determined that? You kind of used the words interchangeably in your testimony.

Secretary THOMPSON. It is based upon expenditures because of the States' match and the Federal match.

Senator MURRAY. But for those of us States who have to return our SCHIP dollars because we haven't been able to use them——

Secretary THOMPSON. But under this proposal, you would get your allocation and be able to use it. It would not be sent back.

Senator MURRAY. That is where I am challenged with understanding what you are saying. If you base it on expenditures after we have had to return some, that is a very different formula funding than if you base it on what our allocation is.

Secretary THOMPSON. It is different. Under Medicaid, it has to be based upon expenditures, because there has to be a State contribution. It will be less under the new provision than it is under the old, but it is still there.

SCHIP is going to be allowed to go to the State and be given to the State, and there will be an allotment given to the State, but it will be on top of the Medicaid proposal.

Senator MURRAY. Then, you are saying it is based on the allocation.

Secretary THOMPSON. It will be an allotment allocation to the State of Washington. So you will not have to send your SCHIP money back. You will be able to use your SCHIP money in the State of Washington not only for children but for low-income parents.

Senator MURRAY. Let me turn to Medicare, because that is a huge issue for us.

Secretary THOMPSON. I know it is.

Senator MURRAY. I think we all know that we need to modernize Medicare and increase prevention, but I am very concerned that if we turn Medicare over to the private insurance market, we are going to add to the current inequities in the system. I know you have said many times in the past few months that seniors will not be forced into HMOs in order to receive prescription drug coverage, but I think it is pretty clear that the Administration is looking to expand the role of private insurance in Medicare, and to me, that approach is fairly troubling. I think we have to remember that Medicare was created a long time ago because of the failure of the private insurance industry.

Secretary THOMPSON. That is true.

Senator MURRAY. If we look at Medicare-Plus-Choice right now, we see some pretty painful limits of private insurance. It works great in some of our large urban areas, but in a lot of places in my State, it does not work well. Some States have plans that offer prescription drugs or vision benefits, but seniors in my State do not have access to that.

Let me put up this chart. I know that you know this; we have talked about this before. This is the Medicare reimbursement chart that shows a number of States—or, the inequities in the Medicare reimbursement system that Senator Wyden actually referred to a few minutes ago. We see where Louisiana gets reimbursed at over $7,000——

Secretary THOMPSON. Take a look at Wisconsin.

Senator MURRAY. Yes, you are down there with us.

Secretary THOMPSON. Yes, I am right down there; you had better believe I am.

Senator MURRAY. This is my concern. There is a huge gap, and if these amounts are used to determine the Medicare-Plus-Choice reimbursement rates, we are going to exacerbate a problem that is already there. It punishes States like Wisconsin, Washington, Oregon, and others——

Secretary THOMPSON. Iowa.

Senator MURRAY [continuing]. As Senator Wyden said, it sort of benefits States that have been inefficient. As he said so eloquently, there is no reason to do anything innovative, to work toward preventive care, to try to make changes. If all you do is reduce your costs, then we get a benefit system reimbursement like this, and if you are going to put your proposals based on these inequities, it is only going to make States not want to do something that reduces their costs.

Secretary THOMPSON. You have said a lot of things, most of which I agree with, so let me try to answer and allay some of your fears.

First off, the Medicare-Plus-Choice program is HMOs. The model that we are talking about is not an HMO model.

Second, you are very satisfied I am certain about the Federal Employees Health Benefits Program, and your Federal employees in the State of Washington have many choices, and every one of your Federal employees in the State of Washington is covered under the Federal Employees Health Benefits Program. That is the model that we want to use in the Medicare system.

Finally, most of the reimbursement formulas are statutory, and I cannot change them.

Senator MURRAY. But you can give us proposals to change them.

Secretary THOMPSON. I can give you proposals. I could set up a committee and sit down and talk to you about ideas and how we can do it.

Senator MURRAY. I think that is important to do, because it is hard for Congress to move forward on this when you have winner States and loser States, and we do not have anything from the Administration to help us deal with this.

Secretary THOMPSON. But this administration—we have only been in office for 2 years, and we inherited this system. We cannot change everything. I am trying to come up with innovative ideas on Medicaid. I have many ideas on the uninsured that I would like to sit down and talk to you about; quality assurance; preventive health—ways in which we can really improve the system. Most people do not ask me for my ideas. I wish they did.

Senator MURRAY. Well, I would like to work with you on this, because if we just base the prescription drug benefit on the same inequities that we already have and the same formulas that we already have, there will be States who are going to lose all over again in a way that just simply is not fair. So I think it is important that we talk about how that formula is going to be—whether you are going to provide a flat per-beneficiary amount, the same for everybody in the country, when you come to prescription drugs, or you are going to base it on an inequitable formula. If you base it on an inequitable formula, you are going to have a number of us who are going to absolutely oppose you.

Chairman NICKLES. Senator Murray, you made an excellent comment, and I concur.

Secretary Thompson, I will again say that several of our colleagues are saying we all recognize that we need to make significant Medicare reforms, improvements, to resolve some of these inequities in the system.

Secretary THOMPSON. Absolutely.

Chairman NICKLES. I will work with them.

Senator MURRAY. Great.

Secretary THOMPSON. You are going to find that this administration wants to work with you and accomplish those reforms. How many of those reforms can be adopted is a political decision, and we have to—the problem is that prescription drugs is the dessert, and unless we are willing to make the necessary changes to strengthen and improve Medicare right now, with prescription drugs being the dessert, we will never get back to Medicare and make the necessary changes until it is in a crisis situation.

So I think we have an opportunity this year.

Senator MURRAY. Mr. Secretary, let me just say that if the only people who get the high-calorie dessert are the people with the high-calorie dinner, we are all going to be overweight, and this Medicare program will never work. [Laughter.]

Secretary THOMPSON. You know me—I have everybody on a diet in my Department, so I do not like that, Senator.

Chairman NICKLES. Well-said.

Senator Gregg.

Senator GREGG. Well, there is nothing that kills good policy faster than a good formula fight. I sympathize with the Senator from Washington because our State is in the same situation as hers, but stepping into the territory of formula fights can really undermine policy very quickly.

Secretary THOMPSON. You are absolutely correct, Senator.

Senator GREGG. We should probably fight out the formulas amongst ourselves, and the Administration should set policy.

On the issue of policy, I am interested in the basic theory here of your Medicaid proposal which, as I understand it, is that you are going to incentivize States to be more efficient with their dollars, create more preventive activity, create more health care cost containment by giving them more flexibility over how they use their Medicaid dollars. Is that essentially where it is?

Secretary THOMPSON. That is correct.

Senator GREGG. The theory is that you are going to give them more up front because when they produce more preventive health activity and more efficiencies, they will be able to do more with less as they move out into the outyears. Is that the theory?

Secretary THOMPSON. That is the theory.

Senator GREGG. Historically——

Secretary THOMPSON. But they will still not do less because it is still growing.

Senator GREGG. Right. The basic Medicaid population is required to be covered under any scenario.

Secretary THOMPSON. That is correct.

Senator GREGG. But theoretically here, and arguably, a State will get more money to use for its optional population and use it more effectively for that population because they will have more flexibility over it, and they will know they need to use it more effectively because in the outyears, they are going to have to do more with less; right?

Secretary THOMPSON. That is correct.

Senator GREGG. Some States have occasionally used the Medicaid money in a fungible manner, and——

Secretary THOMPSON. In a what?

Senator GREGG [continuing]. In a fungible manner——

Secretary THOMPSON. Yes.

Senator GREGG [continuing]. I am just wondering what sort of protections there are to address that.

Secretary THOMPSON. States have got the statutory authority to change their optional programs, because there are no restrictions. They can change the optional programs, and they can ask for waivers. We have to make sure that the waivers are budget-neutral. That is the accountability. The optional programs are still going to have a limitation based upon the dollars and the flexibility that is granted, but there is going to be a lot of flexibility for them to develop the program, as you indicated, Senator.

But the mandatory populations, the mandatory options, and the mandatory protections, are all still existing in the law.

Senator GREGG. I understand that. Is there going to be within the waiver application a requirement for preventive activities and good health care and things like that?

Secretary THOMPSON. We are going to set up——

Senator GREGG. They are not going to be that categorical; it is just going to be simply here is the money, and we encourage you——

Secretary THOMPSON. We are going to set up a clearinghouse in the Department in which we are going to make prevention the key element, and we are going to send out these templates to each and every Governor and State legislature and say these are the kinds of things that we think you should do with your program; it will save you money and improve the quality of health for your citizens.

Senator GREGG. Let me move on to another subject because my time is limited here. The Bio-Shield program that you proposed—is it your view that this should be a mandatory funding stream or come through discretionary funding?

Secretary THOMPSON. We think it should be mandatory.

Senator GREGG. You are thinking of $6 billion over what period of time?

Secretary THOMPSON. Six billion dollars over 10 years.

Senator GREGG. Do you think this should be joined with addressing the issue of compensation for injury and liability in order to get utilization of this funding stream up?

Secretary THOMPSON. We do not think so, Senator. I know that has been a concern of yours. We do not believe that you should tie the two together. We think this is a whole new concept that is going to be very difficult to pass in this current thing; putting anything more on is going to be more difficult.

Senator GREGG. Well, if we look at the experience under smallpox, it appears that there are two reasons why smallpox vaccinations are not progressing very effectively, or at least in the expansive way that we had hoped. One is that people do not perceive the threat, I think, and that is unfortunate, because the threat is real——

Secretary THOMPSON. That is correct.

Senator GREGG [continuing]. If it hits, it is going to be multiple. It is not going to be a single incident, in my opinion; it will be all over the country. If you are going to attack us with a biological weapon, you are not going to just attack one place—you are going to attack 20, 30, 40 places, and the panic will be considerable, and the response will be very difficult to coordinate.

But the second element appears to be the fear of lack of compensation should there be an injury. Why wouldn't you think the same framework would play into the effort in Bio-Shield, where you are going to bring on line vaccines which are fairly unique for fairly unique diseases, diseases which represent a national security threat, and people who are getting those vaccinations are going to want to know, well, if it does not work the way everybody says it is going to work, am I going to have a chance to get some sort of compensation.

Secretary THOMPSON. Senator, you are absolutely correct in your analysis of smallpox. These are the two issues that are causing us a lot of concern, because people do not perceive as big a threat as you and I both know it is.

Second, we think that it is the compensation. I have talked to the Association of Nurses and the hospital associations and the SEIU, the employees union, and all of them indicate that they would be more than happy to cooperate much more so and enthusiastically, I might add, if in fact we have a compensation fund. We are working on that, as you know. I believe my staff has been meeting with your staff, and OMB staff has been meeting with you on that particular question.

We think that Bio-Shield really is not to the implementation of the counter-measure. We think it is in the development as well as getting it approved and being able to get it manufactured and getting FDA to grant its approval. We think that utilization as the next step is something different and should not be tied to Bio-Shield.

Senator GREGG. Thank you.

Chairman NICKLES. Senator Gregg, thank you very much.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for your service, and I commend you on wanting to bring some flexibility for the States. Coming from State government myself, I know that the concern, as Senator Wyden mentioned, is that in return for flexibility that the States will be left at some point having the flexibility as to whom to eliminate from health care services, and that is the concern about whether or not resources will be there in the long run. I think I would like to have the opportunity to work with you as well, with others, on that piece, because I think that that is a very, very big concern as to what that flexibility ultimately means for people.

I wanted to just make a couple of comments and then ask a couple of questions. First, I think it is important when we are always talking about numbers and we are talking about optional services under Medicaid and mandatory to really talk about what those are, because “optional” sounds like they are really not needed.

Secretary THOMPSON. This is very important.

Senator STABENOW. Yes. Ultimately, we are talking about health care for people; we are not talking about buying a car—although I would like everyone to buy three or four and buy them from Michigan——

Secretary THOMPSON. At least manufactured in Michigan.

Senator STABENOW [continuing]. That is right—but the reality is that this is health care that we are talking about. It is not a pair of shoes, it is not a car. It is not something that people are running out to do, getting sick just so they can go get health care.

So when we look at this and the explosion, I think it is important to remind ourselves of the context. We have more people out of work right now, so the number of people on Medicaid goes up. We have 2 million-plus private sector jobs that we have lost in the last 2 years, so we have more people going onto Medicaid.

When we look at optional, what we see is the States trying to respond to things that certainly people do not think are optional. Prescription drug coverage—most people who have cancer or high blood pressure do not consider it “optional” to take medicine. When we look at the other things, prevention is already there. States that are trying to do prevention is viewed as an optional service. Dentures are an optional service. If you do not have your front teeth as a senior, and you cannot eat meat, they probably do not consider that optional. Things like glasses are considered optional.

I just mention that because these are not optional as in not necessary for someone. They are just optional in the way we have designed the program, the bureaucracy.

The same thing with the individuals—according to the Kaiser Commission on Medicaid and the Uninsured, they say that many optional beneficiaries are among the most vulnerable people enrolled in Medicaid, including disabled individuals and the elderly who need nursing homes. Again, if you have a mom or a dad who needs a nursing home, that family certainly does not view that as optional.

So I just say that to say that it is important to understand that these are optional only because we have chosen to call them optional, not because people consider them optional in their lives.

The other thing I would just comment on—and I would like to talk about prescription drugs for a moment—is that when we talk about choice, I understand that you are talking about lots of different choices or kinds of insurance systems. I am pleased that you are no longer saying—at least the initial information we had was that people would have to go into an HMO under Medicare in order to be able to receive help, and in Michigan, that has been a real failure. In fact, my mother was in a Medicare HMO and had a very good experience but was dropped along with over 36,000 seniors because plans were pulling out of Michigan. So this has been a serious, serious issue for us.

But when I hear about choice from people, they are not asking for more insurance companies to choose from. They are asking for prescription drug coverage. They think that Medicare works. It is dependable, it is reliable. It has worked except for one thing—it does not cover prescription drugs.

What my seniors are saying is that the choice they want is the choice to pick their doctor, the choice for their doctor to pick their medicine.

So I appreciate where you are going, but that is not what I am hearing from people in Michigan. That is not the choice that they are wanting. The choice that they are wanting is to be able to have prescription drug coverage, and I want very much to work with you to have something that makes sense.

On prescription drugs, one of the things that we have not talked about today is why we are seeing an explosion in health care costs. I hear from business after business in Michigan, including the Big Three, that the biggest reason their health care costs are going up is because of the explosion in prescription drug prices. Doctors are getting less money—although I am glad we could address their concerns in the last budget. I wish we had addressed hospitals and nursing homes and home health agencies and others. But no one else is seeing large increases in reimbursement, yet the average brand name prescription drug is going up three times the rate of inflation, and that is being paid for by business, it is being paid for by individuals, and so on.

So I would like to talk to you about the whole question of how do we bring these prices down. If we continue paying prices that are three times the rate of inflation, and we just add Medicare coverage, we break the bank. We have to deal with the question of prices.

We had a bill that passed the Senate, Senate bill 812, last year that closed loopholes on generic drugs. I know the President has moved forward part of the way on that, and I commend the Administration——

Secretary THOMPSON. We think quite a bit of the way.

Senator STABENOW. I guess my first question would be will you support going the additional steps in order to really close the loopholes. It is my understanding that things like enforcement of the new Orange Book listings, late-filed patents, collusion, and other important elements in S. 812 have not yet been implemented, and I am wondering if you are willing to work with us to take the bipartisan bill passed with over 70 votes in the Senate—Senator Schumer and Senator McCain's bill—would you support doing the rest of the job in terms of generic drugs so that we can lower prices?

Secretary THOMPSON. You have raised many things. Can I go through them——

Senator STABENOW. Sure.

Secretary THOMPSON [continuing]. First, on Medicaid, I know you are from the State and you understand it, but most people do not understand that this is a tremendous buy for the States because it is going to lessen their payments each year to get the Federal dollars. So the Federal share will go up, and the States' share will go down.

So over a period of time, even over this 10 years, the States' involvement will be less, and the Federal involvement will be more, because they will not have to pay as much in on an annual basis.

It equates to about a 1-percent increase in the Federal match.

Second, under the existing Medicaid law, it is so strict—for instance, you mentioned that you have some companies that are closing down——

Senator STABENOW. Many.

Secretary THOMPSON [continuing]. The State cannot go in and do anything for those poor people under the Medicaid law. It does not allow them to. Under this provision, the States could have the discretion to go in for a period of time and pay the health insurance for those employees under the Medicaid system.

Senator STABENOW. I appreciate that. I also know there is a tradeoff in that if there is a pot of dollars, and they are moving it to those who are unemployed, then it means they are not able to do prescription drug coverage or they are not able to handle senior citizens' dentures and so on.

Secretary THOMPSON. But it is an optional thing. Right now, 38 States this past year have cut back on optionals; 42 States are going to cut back this year. The States—and you will know this from your background—do not have a choice. When they get to the point where they have to make a decision, they have to drop the whole class or the whole option. They cannot redesign the program.

Under the new provision, let us say the States have one or two choices right now—maintain the program as it is or drop it—don't you think the State of Michigan, the Governor, and the legislature would like to have a third option—maybe lessen the benefits or increase the copays, but allow the program to continue. They cannot do that under existing law. Under the new law, they will be able to.

Senator STABENOW. I do appreciate that, and I do believe that flexibility is a good item. I guess my comments earlier were more toward the lack of our willingness to have health care be a priority. We put all of these boxes out there——

Secretary THOMPSON. It is my priority.

Senator STABENOW [continuing]. I understand that, and mine as well——

Secretary THOMPSON. And the President's.

Senator STABENOW [continuing]. But there is not a sense of urgency about addressing what is an urgent matter for people in their daily lives.

Secretary THOMPSON. I think this is extremely urgent, and that is why I am pushing it so hard and trying to elicit your support, because I know that you understand it, and I think you should support it, because I think it would be great for Michigan.

Senator STABENOW. One other quick question, if I might——

Chairman NICKLES. Senator Stabenow, you have already gone about 10 minutes. Let me call on Senator Enzi now.

Senator STABENOW. Well, I will follow-up, because I did want to ask you also about the dramatic increases in advertising for prescription drugs and how that affects our pricing. So I would like very much to follow-up.

Secretary THOMPSON. You asked me if I would like to assist you.

Senator STABENOW. We need to bring prices down, because it is a tremendous pressure on the economy at this point.

Secretary THOMPSON. Well, there are things that we can do, and I think we can do it together, and I am willing to work with you.

Chairman NICKLES. Senator Stabenow, thank you very much.

Senator ENSIGN.

Senator ENSIGN. Thank you, Mr. Chairman.

Mr. Secretary, I have so many questions and so little time. I am very passionate about these issues, as you are, and love some of the things that you are doing and certainly what you did as Governor, leading the country, especially on the welfare reform revolution which really led to the landmark legislation that we passed here in Washington, D.C.

My only charge, I guess, would be to encourage more States to do what you did and not just cut the rolls in half, but cut them up to 95 percent, from what I understand when you were Governor.

Secretary THOMPSON. I only got to 94 percent. I did not get to 95.

Senator ENSIGN. Sorry, sorry, excuse me. I always exaggerate. But certainly the State budgets could use that, and you and I both know that those people are better off than when they were on welfare.

The thing that I have been stressing for a long time also in health care is the importance of prevention. It was one thing that a few years ago, we could not get the bean-counters up here in Washington to score some of the preventive measures. For instance, you mentioned diabetes. Dieticians working with diabetics, teaching them how to eat better, is crucial. When I was in the House, I authored a bill to do that. We were only able to get the study. Now we are going forward with some more things like that such as the idea of physical therapy caps. It just makes a lot more sense if you can get somebody through physical therapy and get them back into society instead of having to be institutionalized or in a nursing home or whatever. Those are some simple solutions, but those are still tiny compared to preventing the onset of diabetes in the first place. Other important health issues we need to address are the smoking problem, eating right and exercising. If you do those three things, you will, as you said, dramatically cut the cost of prescription drugs, the cost of health care, and the cost of hospitalization. We are talking about doing that kind of stuff with some of the older populations, but unfortunately, our kids are being trained in the worst possible habits today. The junk food that they are feeding our kids in schools is promoting the worst possible eating habits. They allow soda pop machines in our schools because that is a way they can make a little extra money. The claim that kids will not eat good food if we feed them is not true. Well, if that is all that you feed them, they will eat it. [Laughter.]

Secretary THOMPSON. I really like you.

Senator ENSIGN. Well, it is one of those things we learn at home first. When my wife and I—and we are just as soft as any other parents sometimes—we give them too many choices. But then, we finally say, "You know, this is really ridiculous. Instead of giving them three or four choices for dinner—no—this is what is for dinner tonight, and you are going to sit there—and there is no snack—

and you are going to eat your vegetables, and you are going to eat the right things." Training our kids when they are young is absolutely critical in this.

A big part of this is leadership from the President in talking to kids and then setting up programs through the Department of Education. Specifically, in Medicaid and Medicare, can you give me some feeling—I know you do not have the exact specifics on what you are going to encourage the States to do—but can you give me some idea, for example, on smoking. My State leads the country in the number of smokers and smoking-related deaths. A large part of that is because a lot of people move to Nevada and work in the casinos and there is a lot of smoking in the casinos.

Secretary THOMPSON. On smoking, I am trying to come up with some discretionary dollars to use in the program to have people stop smoking. Seventy percent of people who smoke want to stop; they just do not have the intestinal fortitude to do it, they do not have the medicine, the counseling, and so on. I think it would be smart of we had some dollars with which we could utilize programs that are out there that are effective when people want to stop smoking. Get it advertised, get it throughout the State Medicaid program, and say these are some programs that will help you stop smoking. If 70 percent want to stop smoking, let us help them. It would save us many dollars in the future—$155 billion a year on tobacco and 400,000 deaths. That is the one best way in which we can have the biggest and most direct impact on the health care budgets in America.

Senator ENSIGN. Once again getting back to the kids, does it make any sense to anybody else that kids are not allowed to buy cigarettes, but we do not do anything if they smoke cigarettes? If you walk onto the parking lots at high schools, the kids are smoking cigarettes; yet it is against the law in my State to buy them.

Secretary THOMPSON. It is against the law to buy them.

Senator ENSIGN. It is against the law to buy them, but they can go ahead and smoke them. Personally, I think we are sending the wrong message.

The other commentary that I would like to make on smoking is that I think Hollywood and the music industry have a huge responsibility here. We always hear about the evils of the tobacco companies and the way they are persuading kids. I remember growing up and remember how companies used to go after Hollywood actors to get them to endorse their products because they knew how important stars were in influencing people's behavior.

Well, in almost very major motion picture and in many music videos what are the people doing? They are smoking. The lead actors make it cool. So that is something that I think Hollywood needs to be held accountable for. We know that if we can get people not to smoke by the time they are about 20 years old, the chance of them smoking is incredibly small. So that is a huge area in the future to save on health care costs.

Secretary THOMPSON. All I can say is amen. You are right on. I wish I could put you on every television station in America.

Senator ENSIGN. Mr. Chairman, can I ask one more question on prescription drugs?

Senator Hagel and I had a prescription drug bill last year that we actually got 51 votes on. We ended up having four Democrats vote for our bill. It was the only one that fit within the budget last year. Unfortunately, it did not come through the Finance Committee, so it was subject to a budget point of order.

But it addressed something that I think is fundamentally wrong with our health care system, and that is if you are going to give a prescription drug benefit, and you just give the drugs to people, there is no accountability to the patient.

Our bill said that the patient is going to be responsible for the first dollar expenses unless they are very, very poor. They would pay up to a certain amount it was around $1,200 and then it went up from there depending on income. But the bottom line was that they paid the first dollars, and after that, the Federal Government picked up the cost.

In health care today, with low-deductible policies or low copays, there is no accountability in the system. One person provides the service, somebody else pays for the service, and one person receives the service, so there is no connection there.

I think it is very important for us when we are designing a prescription drug proposal—because these costs will skyrocket in the future—that we add accountability.

Senator Stabenow talked about that somebody will go out and buy a car just to buy a car, but they do not just go out and get health care. That is bunk. People go out and get prescription drugs. There are a lot of hypochondriacs in this country, and there are a lot of seniors who are lonely, and they may go to the doctor to have somebody to talk to. We know there is a tremendous amount of overutilization. There has got to be some accountability in the system for some of the costs; otherwise health care costs will continue to spiral out of control.

So we really want to continue to work with you and your staff, to try to make sure that the prescription drug proposal that is enacted in is not only good for seniors but is responsible to the next generation.

Thank you, Mr. Chairman.

Secretary THOMPSON. You raise some very valid points, and I want to work with you very much, Senator. Thank you very much for your comments.

Chairman NICKLES. Senator Ensign, thank you very much.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Welcome, Mr. Secretary.

Secretary THOMPSON. Thank you, Senator. How are you?

Senator CORZINE. I, like my colleagues, appreciate the flexibility and creativity that you have tried to bring to a complex subject. I think the preventive care elements that have been talked about repeatedly are extraordinarily important elements of trying to rein in costs, and I hope that all of us can be a part of the process to make that more a fundamental element of what we are trying to do here.

I do want to express, though, some frustrations. It strikes me that in a number of States—I am obviously reflecting the experiences that we have in New Jersey—where people have been creative, where they have been flexible, where they have moved in a forward-looking way, for instance, with regard to prescription drugs, and made choices, it would appear—and again, obviously, since I have a vested interest in representing my State—that they have often been punished, or at least not rewarded, for those kinds of innovation and flexibility.

The same thing with the SCHIP. Our State has been one of the most aggressive under both a Republican and a Democratic Governor, in a bipartisan way, in reaching out to register.

Secretary THOMPSON. You have done a good job. Congratulations.

Senator CORZINE. They have done a great job. But it is unclear to me—well, first of all, there is the technical issue of the reallocation, which the current administration is looking for in this difficult time, and I guess CMS has not moved to actually reallocate those funds this year, which is a problem, one of several, with regard to what people would count on in their budget based on what the law said and what was supposed to happen. I can understand why you want to correct and use it in other States, appropriate in the long run; I think that is a good idea. But at least as the law works today, there are supposed to be funds that are flowing to 13 States, and a decision on that has not been taken, and I think that just compounds some of the other issues that go on.

I am also worried about where SCHIP will fit in the reform program that you are suggesting—the flexibility program that you are suggesting. Will those funds that are allotted be required to be used for SCHIP, or will they fit into a larger block that potentially will pull away from kids? I know you talked about acute care and long-term care. One of the most successful bipartisan initiatives that has come out in recent years, at least in my view and certainly for New Jersey, is the SCHIP program and its application to bring more kids in. I am very concerned that the dough that gets block-granted here then moves away from that particular area and will not be used for dealing with children's health, which is such an important issue for education, and then have long run implications. So I would like to hear how you think that is going to work.

I am going to be remiss again if I do not say something about I thought your initiative to make sure that SCHIP could be used for low-income pregnant women and the confusion with the fetus as opposed to the child is a concern of mine. I think we are getting issues that do not necessarily relate to what I think is a very, very important issue to be prenatal care, post-partum care, for low-income women and children mixed up in another debate, and I would encourage that we reconsider and move on that.

But most of my questions, a lot of them, are not unlike what my colleagues brought forward, but this SCHIP issue I think may be one of the vital areas in Medicaid that I am very concerned the reforms will undermine.

Secretary THOMPSON. Thank you very much, Senator.

Let me go down the list. First, you are concerned about the waiver being applied for by the Governor of New Jersey on drugs. I had a nice meeting with the Governor this week. I was with him and his staff I believe on Friday for an hour and a half, and we worked through as much as we could.

The problem I have is one in which the law requires me to be budget-neutral. I cannot break the law. So we are trying to work out different figures which might be able to give New Jersey some relief. We are working on that. I cannot promise you; all I can tell you is that we are working on it, and I think the Governor was quite satisfied with the meeting, and hopefully we can make some progress.

On SCHIP, I understand that New Jersey would like to get the reallocation. If I were New Jersey, I would love it, too. I just think the concept of States like Washington, Oregon, New Mexico, and Tennessee—the States that cannot use their SCHIP because they were out in front and developed the program that is too rich now for SCHIP to fund—that they should not be penalized by not being able to get the SCHIP dollars. We are trying to——

Senator CORZINE. I would only remark that I thought that that was dictated by law. Maybe we ought to change the law.

Secretary THOMPSON. That is dictated by law.

Senator CORZINE. Therefore, sort of in the same way that you spoke about the other issue——

Secretary THOMPSON. I am talking prospectively, and I think you will agree with me on that.

Senator CORZINE. I actually think that IGT and all the other things—if we had a level playing field, people would be a lot less frustrated about how these things work.

Secretary THOMPSON. I agree.

Senator CORZINE. I suspect the Chairman is going to ask about that upper payment limit in the same way.

Secretary THOMPSON. You have the upper payment limit, you have the IGs, you have disproportionate share—all of those things.

Senator CORZINE. I guess my point is that in a number of instances where you have been good citizens, and you have been creative and used the flexibility that was available and some resources that the State put in to make sure it happened, it does not always work out to your advantage in the transition.

Secretary THOMPSON. No, it does not. In my own State of Wisconsin when I was Governor, one of my biggest gripes was because we were being very progressive and doing some neat things, and we always got penalized for doing that.

Senator CORZINE. It is a concern as we go through a reform toward flexibility and the kinds of innovations you are talking about—and I think this is what Senator Wyden was referencing—it may end up having some hardships for those who have already done a lot of the things or have begun to do a lot of the things that you are suggesting.

Secretary THOMPSON. In the SCHIP program part of Medicaid, we want to be able to use more flexibility. I think the SCHIP program has been an exceptional one, but there have been some problems with it, and the problem I see with it is that it does not allow the parent or parents of that child to also be enrolled, and I am looking for ways to be able to do that, and that in the SCHIP program will be able to be utilized by the States to do that.

I developed a very successful program in Wisconsin doing that. It saved money, and it got more children enrolled—it took me 24 months to get a waiver from the Federal Government in order to do that. That is part of this provision in this one.

In regard to the abortion question, I want you to know that that was not considered at all. The Medicaid law allows for prenatal care right now. We just extended the same thing in the Medicaid law to the SCHIP for children. I believe that those children deserve prenatal care.

Senator CORZINE. You would agree that the mother needs prenatal care?

Secretary THOMPSON. I certainly do.

Senator CORZINE. I think we are both on the same page in what we are trying to accomplish here, and at least my reading of the initiative is that that is not necessarily how it gets interpreted.

Secretary THOMPSON. It does not get interpreted that way, and I just want you to know, because I made the decision, and it was based upon making sure that that child would come into the world healthy, and if that child was born to a Medicaid mother, that mother would have prenatal care. But if that child was an SCHIP child, that child's mother could not get prenatal care. That did not make any sense to me.

Senator CORZINE. We agree 100 percent on that, and we need to make sure that we have it in the way that it is meant.

Secretary THOMPSON. That is the reason for it.

Senator CORZINE. Thank you.

Chairman NICKLES. Senator Corzine, thank you very much.

Mr. Secretary, I have just a couple of quick questions that I was not able to ask you. I mentioned the fact of upper payment limit abuses that are presently in the system. The Administration, and I compliment you for this, you have taken action to curtail some of the abuses. A lot of States have really found ways to gimmick the system or almost scam the system where they move repayment rates or reimbursement rates on Medicaid substantially up in a Government-owned hospital, community-owned hospital, or State-owned hospital up to the Medicare limit. They are reimbursed and then they reimburse the smaller amounts. You would end up having basically a Medicaid procedure that would be entirely paid for by the Federal Government. Isn't that correct?

Secretary THOMPSON. Absolutely.

Chairman NICKLES. Now, you have tightened it up, but you do not stop it. You kind of phase it out, but you phase it out over a 10-year period. You save, according to your report——

Secretary THOMPSON. There are five States—which we have preliminarily determined have UPL transition periods phased out over 8 years.

Chairman NICKLES. Eight years. Excuse me.

Your report says that it saves $55 billion. It really seems to me to be a scam. If we eliminated it totally, what would the savings be?

Secretary THOMPSON. I do not know, Senator.

Chairman NICKLES. Would you report that back to us?

Secretary THOMPSON. Sure. It would be a lot.

Chairman NICKLES. I expect that it would be. If you haven't gotten the thrust, I am really concerned about something that is growing from 6 to 9 to 14 percent in cost when I see some of the gains where the States have been very innovative I am afraid that some of the States, now that you have tightened up on UPL, are finding other ways.

Secretary THOMPSON. Yes, they are.

Chairman NICKLES. Some of the State health directors are very adroit, and I would imagine they have hired professionals to figure out how they can make Medicaid a 100 percent Federal program and avoid the State match.

Secretary THOMPSON. That is correct.

Chairman NICKLES. I do not think we should allow that to happen.

Secretary THOMPSON. I do not, either.

Chairman NICKLES. I would appreciate suggestions from you and some of your experts that we might incorporate so we can stop the cheating on the system and come up with a Federal-State program that is run by the States and not have this be entirely a Federal program. If we are going to change it into an entirely Federal program, then let us do it for all States.

Correct me if I am wrong, but in this particular program, I believe there are 28 States that are participating, using UPL, States I would say are cheating on the system.

Secretary THOMPSON. Well, you have the use of Inter-Governmental Transfers, Senator. There are three IGT programs. You have the use of Inter-Governmental Transfers, as part of the upper payment limit; and then you have the use of IGT's as part of disproportionate share and you have began to use IGT's in other payments. Each one of those has some merits, but there are a lot of abuses, and we are trying to tighten up the system so there are not abuses in it. The Inter-Governmental Transfer is the one that right now needs to be tightened up.

The upper payment limit is on a glide-path down to 100 percent.

Chairman NICKLES. I am not convinced that we need to phase it out over 8 years.

Secretary THOMPSON. I understand. There are only five States that are still in the 8-year. Some are at 5 years, some are at 4 years, some are at 3, and some are at 2. But you are going to have to change the law in order to do that.

Chairman NICKLES. Well, I am in that business.

Secretary THOMPSON. I know that, and I am very appreciative that you are, Senator.

Chairman NICKLES. I am happy to work with you. I notice one of your——

Secretary THOMPSON. But I would like to point out that the upper payment limit is small compared to the IGT. That is the one that I am much more concerned about, and I would like to spend some time discussing it with you.

Chairman NICKLES. Could you give me a thumbnail, what do you mean by IGT?

Secretary THOMPSON. It is an agreement between the State and the county. The county for home and community based health care spends $100 for the service. They bill the State for $100 as the rate for that service. But the State says we will increase your rate and you bill us $200, we will then bill the Federal Government $200 for that service. Then, if it is a 50–50 matching State, the Federal Government pays to the State on a quarterly basis $100 for this bill, because the Federal Government's share is $100, and the State's share is $100. So in this example the State was supposed to pay $100, and they get $100 for this from the Federal Government, and they pay the $200 to the county; the county keeps $100 plus $25 commission and sends $75 back to the State. So the State has only provided $25 instead of their statutory match rate of $100 in this example.

Chairman NICKLES. Are you talking about for home health?

Secretary THOMPSON. For anything—for doctors, for home health—anything that includes counties or local providers.

Chairman NICKLES. All this under Medicaid?

Secretary THOMPSON. Under Medicaid, yes.

So the counties have reached an agreement with the State that they will increase their billing to the State, which increases the billing to the Federal Government, which lowers the percentage the State has to pay because the Federal Government gets the higher bill, and they pay their percentage on the higher bill, and they send that percentage back to the State, and then the State transfers that on to the county or to the city, and the city takes a commission, and they turn around and send the balance back to the State, which lessens what the State's participation is.

Chairman NICKLES. It is pretty close to the upper payment limit.

Secretary THOMPSON. Well, that is part of the upper payment, but IGT is used in conjuction with the upper payment limit and other payment mechanism.

Chairman NICKLES. Is that right? Well, I would be very receptive to some ideas on stopping some of these things. I would like to even go further to tighten them up but impose penalties for the people who are abusing the system. If people are going to be rewarded for coming up with games to figure out how to make this an entirely Federal program, and/or if we include that, I am a little concerned about your Medicaid proposal. I do not want to use the word "block grant," but the level that you are submitting to the State, if they have that built into their base, are we rewarding them vis-a-vis the 22 States that do not do that in setting up the Medicaid program as you have proposed?

Secretary THOMPSON. I am not sure if the IGT is in the base. It is in the base.

Chairman NICKLES. If it is in the base, you are somewhat rewarding them for that. I would hope that as this progresses, we would not have that included in the base. I think that rewards some devious planning. It may be legal, and maybe some people are doing it because they say, "We know that other State are doing it." I notice the number of States that have done this went from 12 to 28 just in the last couple years.

Secretary THOMPSON. Yes, but now there are more.

Chairman NICKLES. Now there are more than that, you are telling me. How many more?

Secretary THOMPSON. I do not know, but we are getting applications every day. There are corporations out there that are making money off this, coming up with ideas. Every time we close one idea, they come up with another idea.

Chairman NICKLES. Well, you know, the IRS is now coming down hard on some firms that came up with tax shelters that were really pretty abusive. I look at this as somewhat in the same vein, and I look at us paying the bill. When I see our Medicaid bills climbing by 14 percent and climbing every, single year percentage-wise, I want to stop this kind of abuse. Maybe we can come up with some penalties for those who participate in this kind of scheming. So suggestions that you have, whether they be the Inter-Governmental Transfers or whether it be UPL or others, I solicit those, I welcome those, I want to work with you.

Secretary THOMPSON. UPL is going down. It is on a glide-path. You do not think the glide-path is fast enough.

Chairman NICKLES. That is correct. Look at the glide-path. If somebody has been ripping you off, and you say, "Next year, if you rip us off a little less, maybe we will be pleased because we are making savings," that does not satisfy me. I think we ought to close the door.

Secretary THOMPSON. I understand that, but that was negotiated before I got here, Senator.

Chairman NICKLES. I understand that, and I understand there are certain hospitals that have done exceptionally well and have powerful members. It does not change the fact that we have to try to save this system, and you are to be complimented because you are proposing the most significant reforms in both Medicare and Medicaid that we have considered, frankly, in my career in the Senate, which has been 23 years. Both need to be improved and saved. So I compliment you for it; I just happen to think we ought to tighten up on these abuses.

We have enhanced and improved some benefits, whether you are talking about prescription drugs, lower deductibles or catastrophics, there are a lot of positive things we can do in Medicare, and maybe more preventive possiblilities in both Medicare and Medicaid. Those are some of the positive things, but likewise if we do not stop some of the abuses, we will not be able to afford it.

So I look forward to working with you and other members of the committee to really make significant improvements in these two major programs, and I appreciate very much your participation before the committee.

I do hope that you will respond to additional questions if submitted to you by myself or others.

Secretary THOMPSON. Thank you very much, Senator, for giving me this opportunity. I really appreciate the cooperation from both sides here today wanting to really take a look at this and work on it.

I think we can come up with a Medicaid plan that everybody can buy into and really support, improve the system, and save some dollars, make it more people covered and more efficient. I know that that seems almost impossible to say, but I think we can do that just like we did under welfare.

Chairman NICKLES. I look forward to that, and we will work together to make that happen.

Mr. Secretary, thank you very much.

The committee is adjourned.

[Whereupon, at 5:01 p.m., the committee was adjourned.]

THE PRESIDENT'S FISCAL YEAR 2004 BUDGET

THURSDAY, SEPTEMBER 3, 2003

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

The committee met, pursuant to notice, at 10:37 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Don Nickles, (chairman of the committee) presiding.

Present: Senators Nickles, Allard, Bunning, Crapo, Conrad, Corzine, Stabenow, and Sarbanes.

Staff present: Hazen Marshall, Majority Staff Director; and Mary Ann Naylor, Staff Director

OPENING STATEMENT OF CHAIRMAN NICKLES

Chairman NICKLES. The committee will come to order. I want to thank everybody for their cooperation. Senator Conrad and I both had some challenges since we are returning this week, and so we moved the hearing from 10 o'clock to 10:30. I understand that Director Holtz-Eakin also has other commitments.

So, Director Holtz-Eakin, I thank you very much. I want to thank my friend and colleague, Senator Conrad, for his attendance, and also Senator Crapo for his participation and Senator Corzine for his participation. You are welcome to come up a little closer, if you prefer to do that. We will call on Senators by their time of arrival.

I will call on my colleague, Senator Conrad, for any opening remarks that he wishes to make.

OPENING REMARKS FROM SENATOR CONRAD

Senator CONRAD. Thank you, Mr. Chairman. Again, thank you very much for moving this hearing to accommodate other hearings and other committees, and welcome to Dr. Holtz-Eakin for his first testimony, I think, before the Senate Budget Committee.

The report that you have just issued should send alarm bells sounding throughout Washington and really throughout the country, because what it tells us very clearly, as a part of a series of reports, is that we are on a course that is utterly unsustainable, and it is going to require us to make substantial changes in budget policy as we go forward.

I go back to what the President told us 2 years ago when he said "Tax relief is central to my plan to encourage economic growth, and we can proceed with tax relief without fear of budget deficits, even if the economy softens." Well, that has proven to be simply wrong.

Bush Administration Said No Fear of Budget Deficits

"Tax relief is central to my plan to encourage economic growth, and we can proceed with tax relief without fear of budget deficits, even if the economy softens."

–President Bush
Remarks at Western Michigan University
March 27, 2001

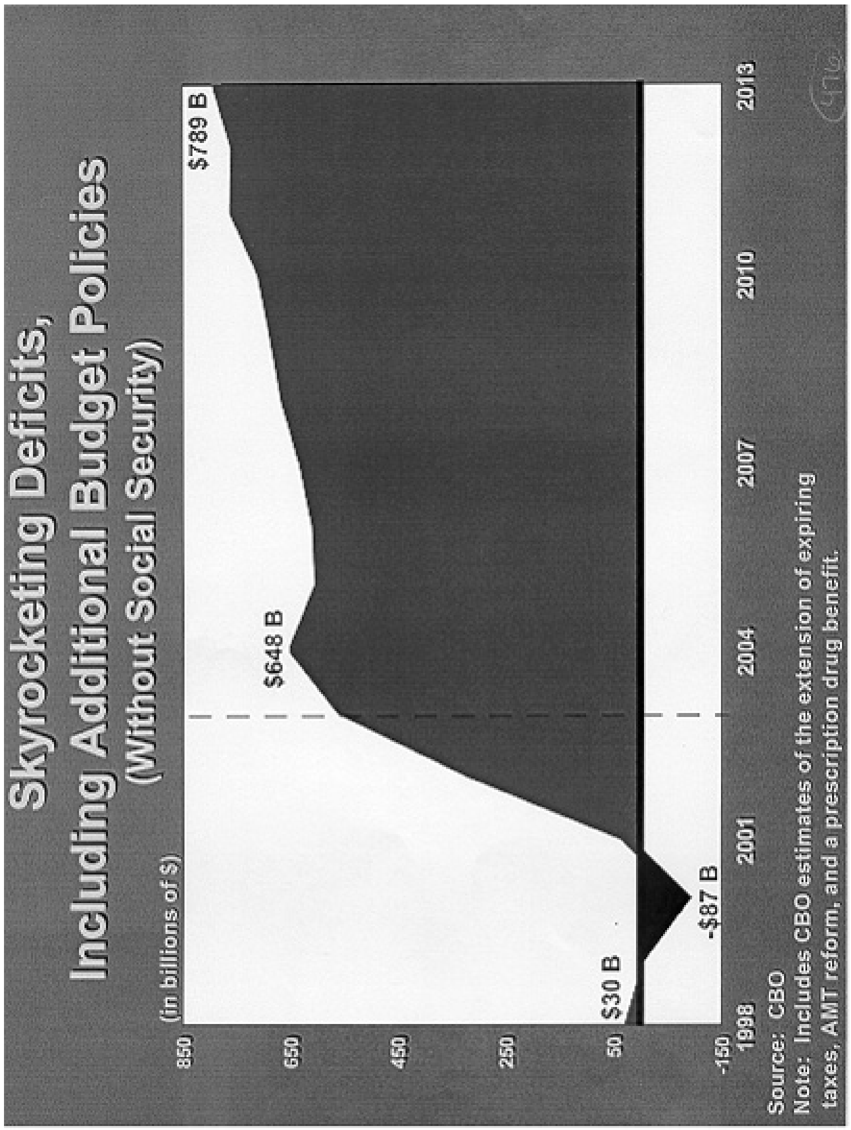
Then, the President told us last year that “our budget will run a deficit that will be small and short-term.” That has also proved to be wrong. These deficits are not small, and they are certainly not short term. They are very large deficits. They are record budget deficits in dollar terms, even large as a percentage of GDP, and we see no end in sight.

President Bush on Running Deficits

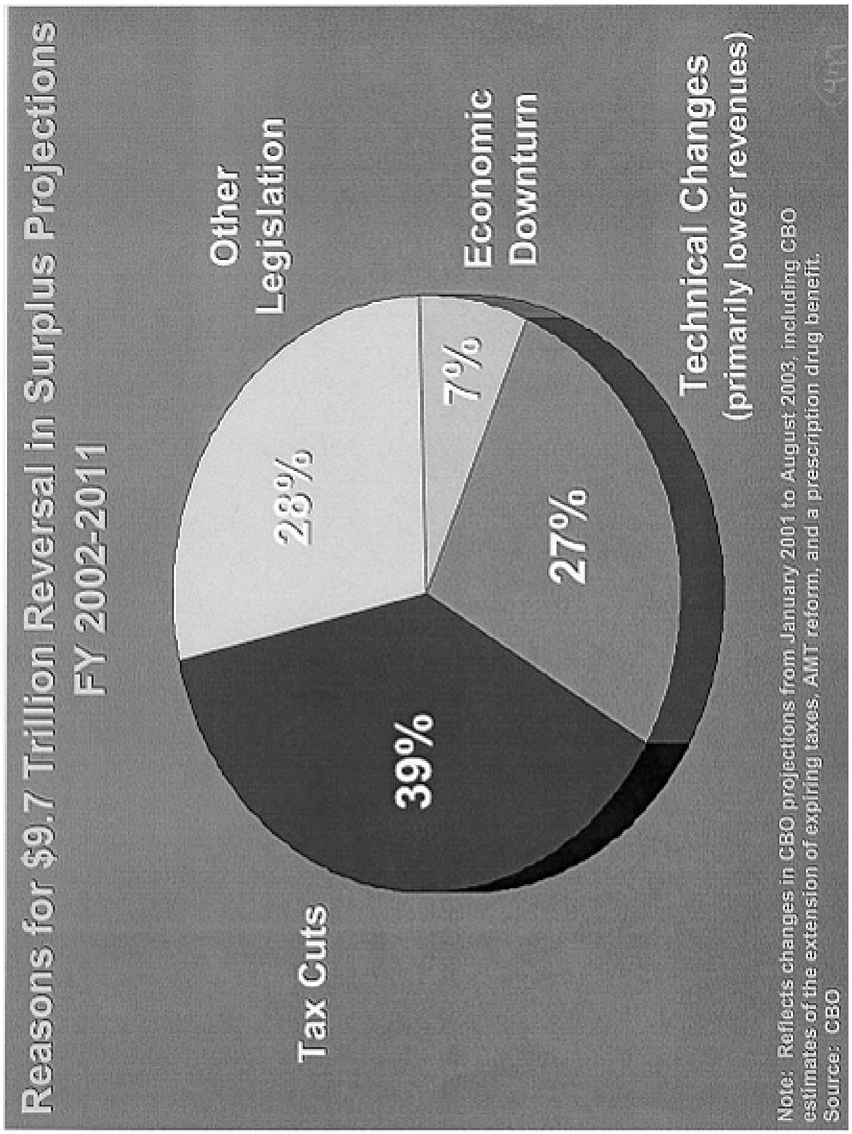
"...[O]ur budget will run a deficit that will be small and short-term..."

–President George W. Bush
State of the Union Address
January 29, 2002

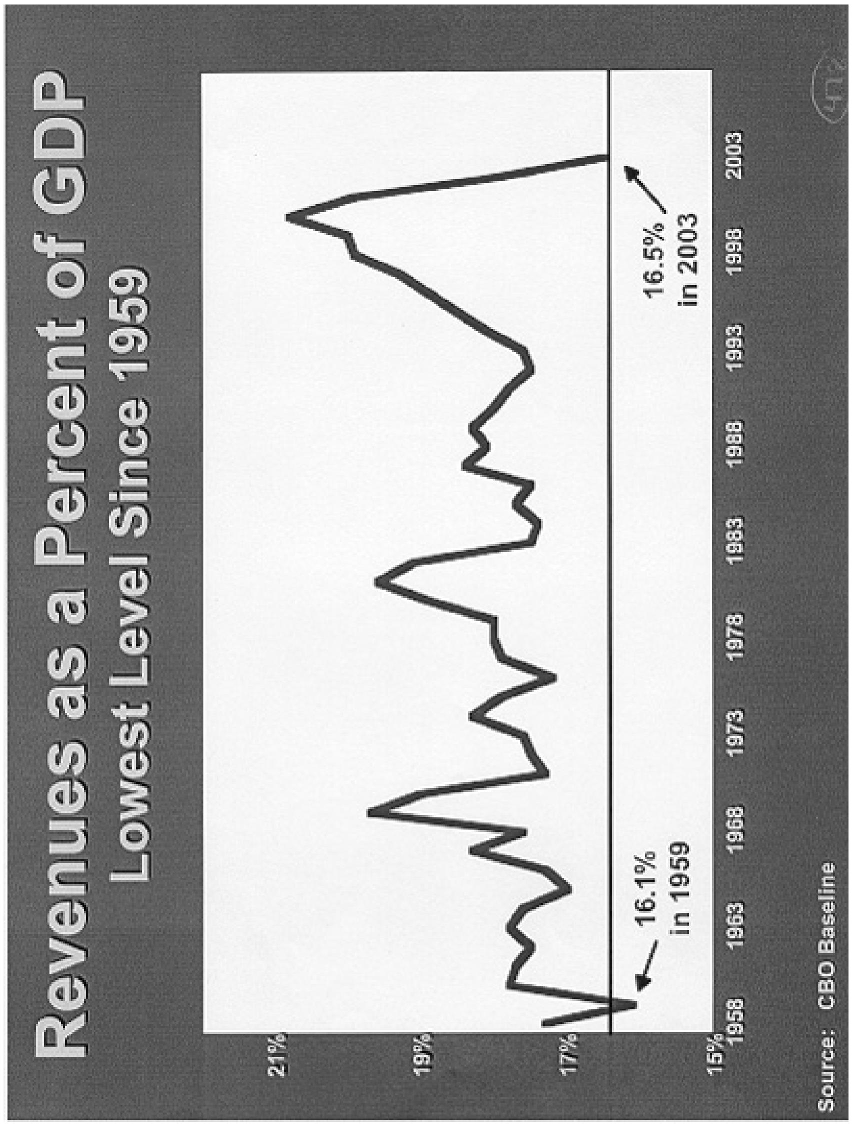
If we look at the report that you have just issued from the Congressional Budget Office, and of course you are required to report in a certain way, you are required to report based on what is, not with changes that people are advocating. But if we take just three of the things that are out there that we all know are going to have to be dealt with, the President's proposal to make the tax cuts permanent, the President's endorsed prescription drug bill, a reform of the alternative minimum tax, which if we fail to do will affect 30 million people by the end of this decade——just those three changes and what we see are deficits that go on for the next 10 years in very large amounts. This also includes, by the way, treating Social Security as a trust fund; that is, not using Social Security Trust Fund surpluses to pay other bills.


Skyrocketing Deficits,
Including Additional Budget Policies
(Without Social Security)
(in billions of $)
850
650
450
250
50
-150
1998
2001
2004
2007
2010
2013
$30 B
-$87 B
$648 B
$789 B
Source: CBO
Note: Includes CBO estimates of the extension of expiring taxes, AMT reform, and a prescription drug benefit.

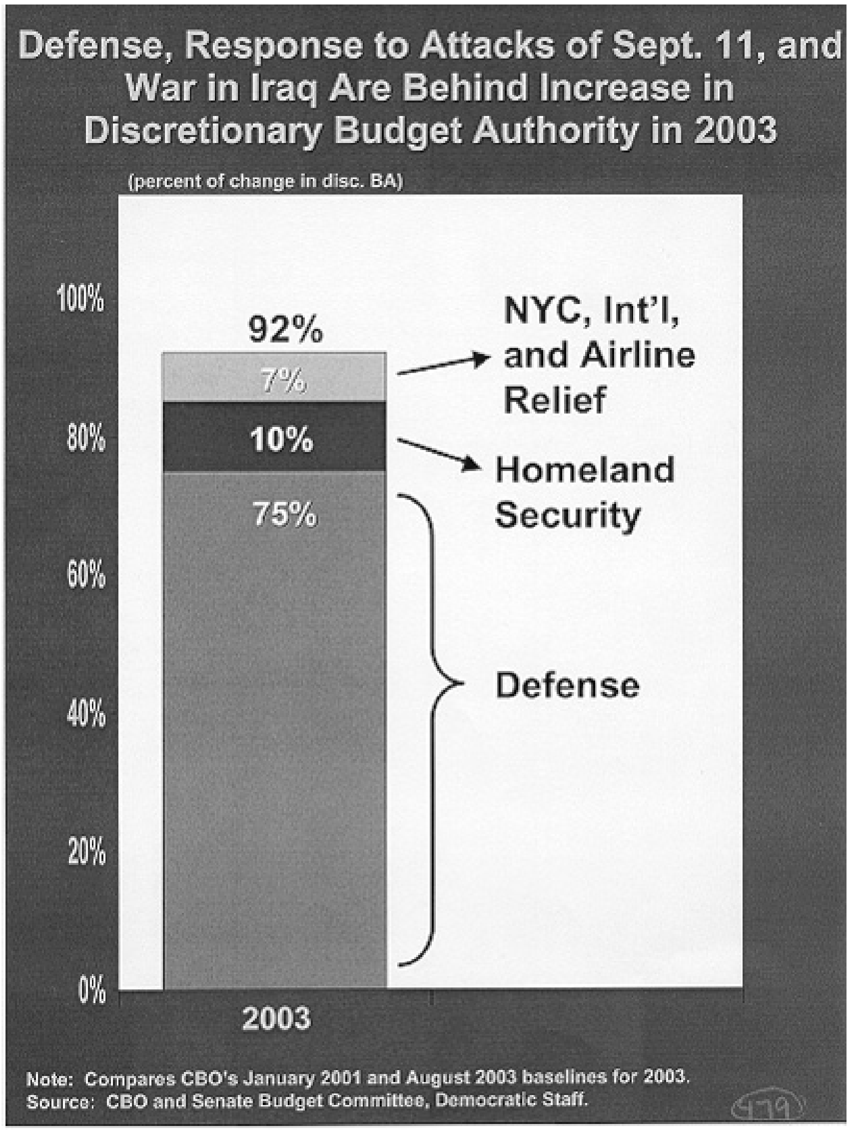
What we see are truly large deficits throughout the entire rest of the decade. When we look at where the money went because, remember, just 2 years ago we were told there were going to be nearly $6 trillion of surpluses, if we look at that same period of time, here is where the money has gone: Nearly 40 percent for tax cuts; 28 percent increased spending, almost all on defense and homeland security; 27 percent technical changes, largely lower revenues not associated with the tax cuts, so almost two-thirds of the loss of the projected surplus and turn to deficit is on the revenue side of the equation and some 7 percent from the economic downturn.


Reasons for \$9.7 Trillion Reversal in Surplus Projections
FY 2002-2011
Other Legislation
Economic Downturn
Technical Changes
(primarily lower revenues)
Tax Cuts
39%
28%
7%
27%
Note: Reflects changes in CBO projections from January 2001 to August 2003, including CBO estimates of the extension of expiring taxes, AMT reform, and a prescription drug benefit.
Source: CBO

We clearly have a revenue problem and a tax and a spending problem. The revenue problem is really quite dramatic, and we have gone from having revenues that were very high as a share of our gross domestic product to now having revenue this year that is projected to be the lowest since 1959. So, clearly, we've got a revenue problem, as well as a spending problem.


Revenues as a Percent of GDP
Lowest Level Since 1959
21%
19%
17%
15%
1958
1963
1968
1973
1978
1983
1988
1993
1998
2003
16.1%
in 1959
16.5%
in 2003
Source: CBO Baseline

If we look at the spending, we look at the increases that have occurred there, look at the increase that has occurred on spending, just for this year, over the baseline, 92 percent of it is in just three areas: defense, homeland security, and rebuilding New York and support for the airlines. That is where the increase in spending has occurred. If you look at the last 2 years, it is the same thing. It is actually a larger percentage for just defense, homeland security, rebuilding New York and the other items I have mentioned, the support for the airlines, and of course the international piece of this because of Afghanistan and Iraq.



Defense, Response to Attacks of Sept. 11, and War in Iraq Are Behind Increase in Discretionary Budget Authority in 2003
(percent of change in disc. BA)
100%
80%
60%
40%
20%
0%
92%
7%
10%
75%
NYC, Int'l, and Airline Relief
Homeland Security
Defense
2003
Note: Compares CBO's January 2001 and August 2003 baselines for 2003.
Source: CBO and Senate Budget Committee, Democratic Staff.
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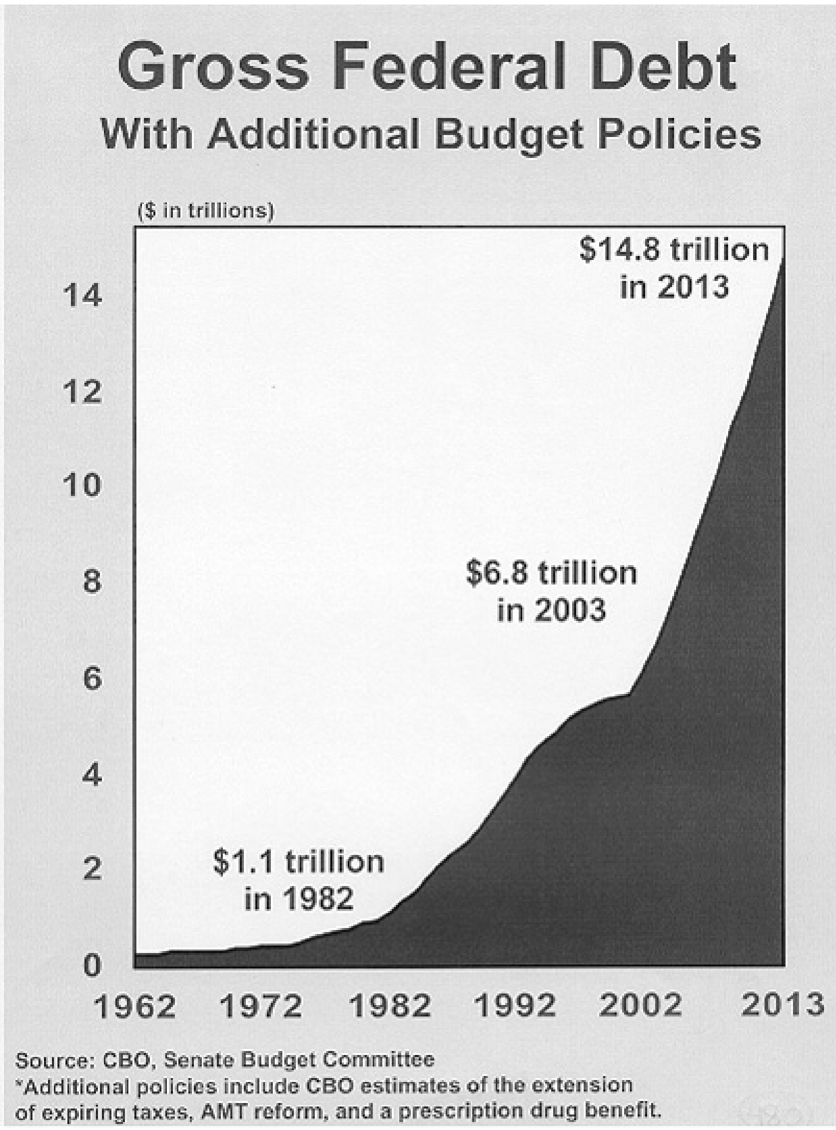
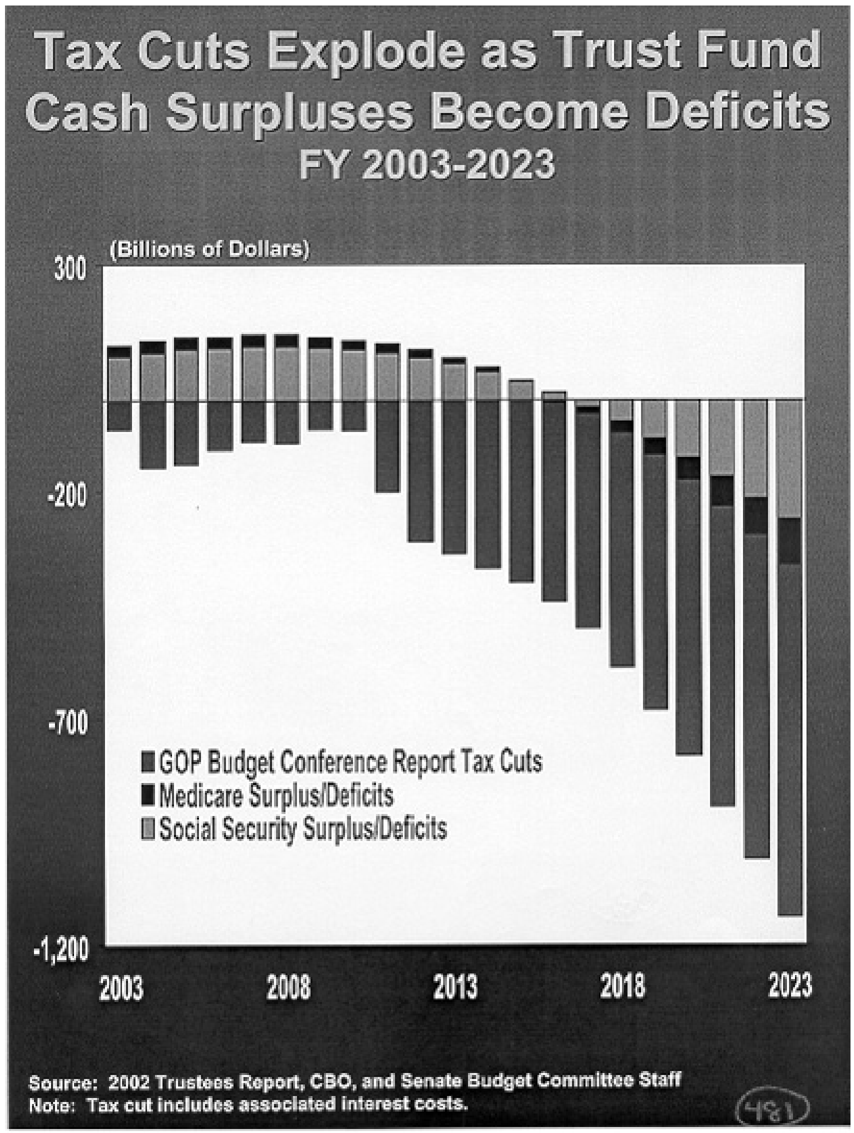
What that leads us to conclude is that the gross Federal debt, instead of being reduced, which we were told would happen, is instead skyrocketing, in fact, it is more than doubling over this next 10-year period to nearly $15 trillion at the end of 2013.


Gross Federal Debt
With Additional Budget Policies
($ in trillions)
$14.8 trillion in 2013
$6.8 trillion in 2003
$1.1 trillion in 1982
14
12
10
8
6
4
2
0
1962
1972
1982
1992
2002
2013
Source: CBO, Senate Budget Committee
*Additional policies include CBO estimates of the extension of expiring taxes, AMT reform, and a prescription drug benefit.

All of this—let us go to the final chart—all of this occurs at the worst possible time, because this is a time we ought to either be prepaying the liability of Social Security and Medicare or paying down the debt in preparation for what we all know is to come. In many ways, this chart is the most alarming because what it shows is that the trust funds of Social Security and Medicare turn cash negative at the very time the cost of the tax cuts explode, driving us deeper and deeper into deficits and debt to levels that are clearly unsustainable.


Tax Cuts Explode as Trust Fund Cash Surpluses Become Deficits
FY 2003-2023
(Billions of Dollars)
300
-200
-700
-1,200
2003
2008
2013
2018
2023
GOP Budget Conference Report Tax Cuts
Medicare Surplus/Deficits
Social Security Surplus/Deficits
Source: 2002 Trustees Report, CBO, and Senate Budget Committee Staff
Note: Tax cut includes associated interest costs.
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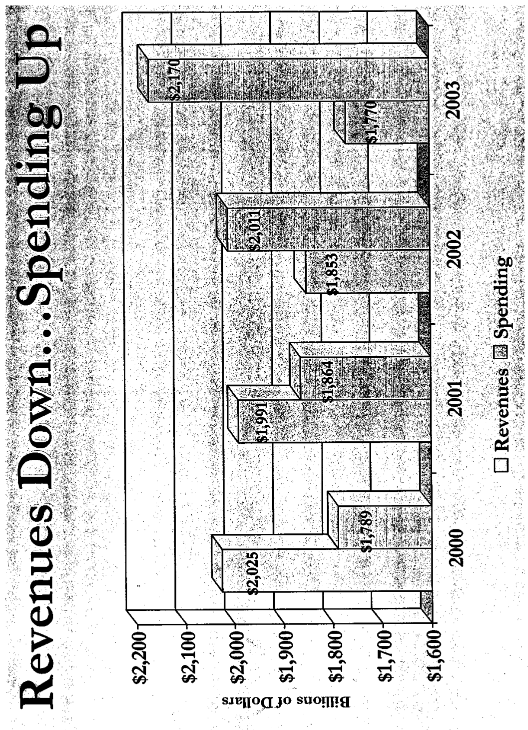
Mr. Holtz-Eakin, I will conclude by saying what you said: that budgets, economics teaches us, are about making choices, and that is really the importance of this committee and the importance of a budget. We have to make choices. I would submit to my colleagues we are going to have to make very difficult choices on both the revenue side and the spending side if we are going to get back on a fiscal course that is sustainable.

Chairman NICKLES. Senator Conrad, thank you.

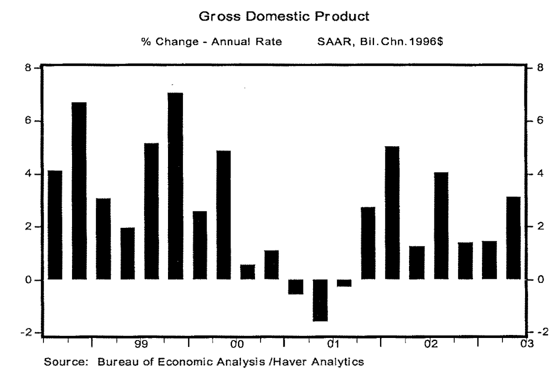
I am going to make just a couple of comments. I do not want to get into a debate with you. I want us to listen to the Director, but I would like to show a couple of charts to give a little different viewpoint. Some of my observations are exactly the same.

Senator Conrad mentioned that we have a revenue decline, and this shows that revenues declined rather precipitously since the year 2000, when we had revenues over $2 trillion a year, forecast this year to be $1.77 trillion. That is a rather significant reduction in revenue, part of which was caused by the tax reduction, part of which was caused by the recession. It also shows that spending—the red figures—have gone up and gone up rather dramatically. Senator Conrad mentioned most of that increase is for defense. We did have a terrorist attack on 9/11, and we have also had a war in Afghanistan and Iraq. Those have been very expensive propositions.

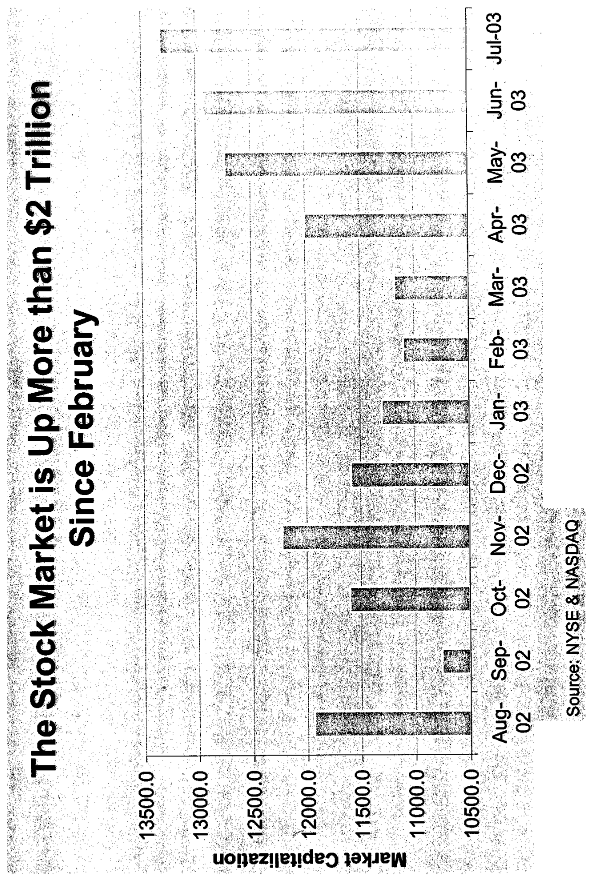

Revenues Down....Spending Up
Billions of Dollars
$2,200
$2,100
$2,000
$1,900
$1,800
$1,700
$1,600
$2,025
$1,789
$1,991
$1,864
$1,853
$2,011
$1,770
$2,170
2000
2001
2002
2003
Revenues
Spending

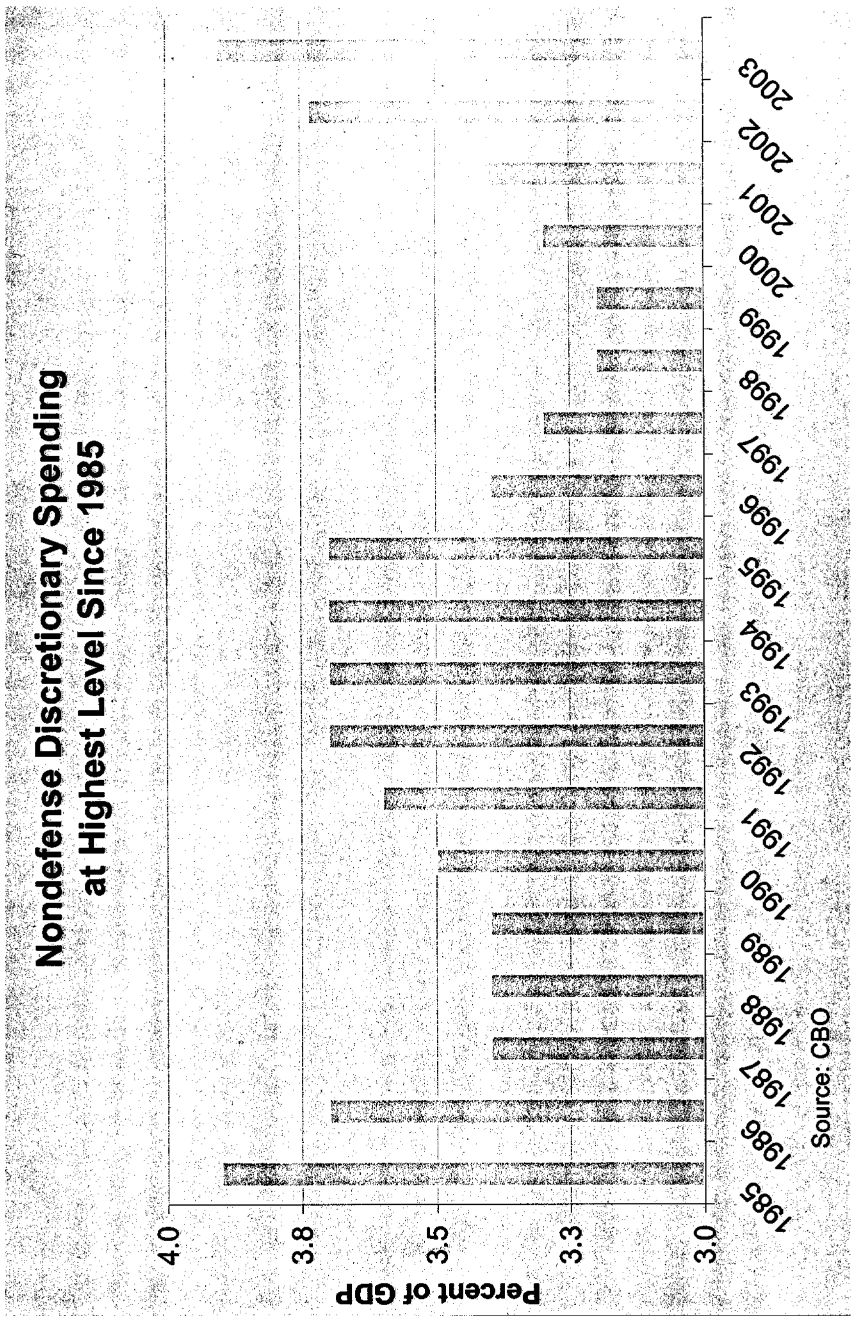
Source: CBO

We have also had spending grow in a lot of other areas. Let me show the next chart.



The tax cuts that we enacted last year have made a significant difference. Many people said the tax cuts would not help the economy, but, frankly, if you look at the economy, since we passed the tax cuts, the economy has grown. Last quarter, it grew at 3.1 percent. That is significant. It has made a significant difference in the stock market, it has made a significant difference in the economy. So we have now had several quarters in the positive. The stock market has gone up over $2 trillion just in the last few months, in the next chart, as well.




Nondefense Discretionary Spending
at Highest Level Since 1985
Percent of GDP
4.0
3.8
3.5
3.3
3.0
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
Source: CBO

I did want to show that nondefense discretionary spending has grown as well. So I just make those points. We are debating the Labor-HHS bill, which has grown dramatically, in double-digit figures, frankly, over the last several years. Spending over the last 5 years, and, Mr. Holtz-Eakin, you can correct me if I am wrong, but I think it has grown an average 7.7 percent. Labor-HHS has grown about 12 percent. So there has been some big increases in spending. I just wanted to allude to those, but also I wanted to point out that, yes, we did make a decision to pass the tax cuts, and I think they have helped.

When we were debating the tax bill earlier this year, I believe Dow Jones was at about 7,500. It is now at 9,500. That is a big change. I think we have made a significant contribution to that change with some of the tax changes that we have made. We will have to make some tough decisions for the future. We will have to make tough decisions on limiting the growth of spending.

In the budget update that we have before us, you assume that the Iraq expenditures, the supplemental, is built into your base, about $80 billion per year for the next 10 years. That is an assumption that will not turn out to be true. I hope it is not true. I hope we do not spend $80 billion a year for the next 10 years. So I hope that is a one time expenditure. Granted, we are going to have some expenses, but it will be significantly less than that, probably hundreds of billions of dollars less than that.

Senator Conrad mentioned AMT. Well, some people said we fixed it. Maybe we can fix it, maybe we can modify it—other changes maybe.

We have a proposal on prescription drugs, and I am concerned about that proposal. Many have said it is not near enough, and I will be working on that. Actually, we are in conference on that as we speak, and I am a conferee, but I hope to make that proposal more affordable for future generations. It could be much more expensive for future generations.

We have a lot of challenges. That is part of what this committee is all about, and we welcome Director Holtz-Eakin to join us. We now have a few other colleagues that have joined us. I would like to call on the Director, unless anybody would like to make a couple of opening comments. If not, I will call on the Director.

[No response.]

Chairman NICKLES. If not, Director Holtz-Eakin, thank you for joining us and welcome to our committee.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, Ph.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, Senator Conrad. It is a great pleasure to make my first appearance before the committee. The report we put together, our summer update to the budgetary baseline, has been out for a week. I submitted the summary of that report as my written testimony, and I thought that in my remarks, I would confine myself to a few of the key points, and then we would discuss things as Members were interested.

Let me walk through it in roughly this order: first, talk a little bit about the facts and then spend a couple minutes on what I think are key features of the baseline projections and close with some observations about the economic outlook that underlies our baseline projections.

First, on the facts. As many of you are well aware, the CBO's summer update projects that the deficit will reach $401 billion in fiscal year 2003. We are projecting a baseline deficit of $480 billion in fiscal year 2004, $341 billion in 2005, and a total of $1.4 trillion in cumulative deficit over the 10-year budget window, with all of that in the first 5 years and a modest surplus in the final 5 years of the budget window.

The dollar figures; the fiscal year 2004 budget deficit are, in fact, the largest ever. But compared to GDP, 4.3 percent is not the largest deficit in recent history. The 6 percent of GDP in the early 1980's is larger. Our baseline projection shows a return to surplus in 2012. Over the course of the budget window, there is a pattern of diminishing deficits and an ultimate return to surplus.

If you look at a different indicator of the fiscal year status of the budget, the ratio of debt in the hands of public, which measures both receipts in and outlays from the Treasury as a fraction of GDP, this baseline projection shows the debt-to-GDP ratio rising from 37 percent at the outset to a high of 40 and then diminishing throughout the 10-year budget window and closing at 30 percent in the year 2013.

So those are the basic facts regarding the outlook that we put in our report, and what I wanted to do was to spend a few minutes talking about what I think are three key features of this baseline projection. We can show the pattern here. This displays—and these charts are in the handouts that I hope are in front of all of you—our baseline projection at this time, and then the one in March that we put out. It shows deficits as a fraction of GDP, and it is also in your handout if we need to look at it more closely, I hope.

Three key features of this projection:

Key feature No. 1 is that it is, in fact, a baseline projection. As Senator Conrad noted at the outset, CBO projects the implications of current law on both the receipts and outlay sides, in performing its baseline projections. And, in particular, this projection embodies the assumption that discretionary spending grows at the rate of inflation, inclusive of the supplemental appropriation in 2003. That supplemental appropriation had $80 billion in budget authority and about $60 billion of that was devoted to operations in Iraq and Afghanistan. The presumption in the baseline is that that would continue and increase at the rate of inflation over the budgetary window.

It also embodies the assumption that the tax cuts, both those passed in 2001 and also those passed by Congress earlier this year, will sunset, as scheduled within the legislation. So our budgetary outlook is a projection, as opposed to a forecast of precise outcomes. It is an implication of current law and serves as a neutral baseline against which Members may measure any changes that they might pursue as a matter of policy.

The second feature I would like to note is that this projection is actually quite similar to the one in March. Its basic character has not changed. It features larger near-term deficits, diminishing throughout the budget window and an ultimate return to surplus. As a result of the legislation enacted earlier this year, both on the spending side and supplemental appropriations and on the receipts side in the form of the Jobs and Growth Tax Act, the near-term deficits are larger. And the projection shows that coming to balance later than we showed in March, but the basic character is similar to the projection that CBO issued earlier this year.

Over the budget window, the projection shows a return to balance in the form of two things:

First, revenues grow, on average, at a rate of 7.5 percent per year during this budget projection, with receipts as a fraction of GDP rising from a low of 16.2 percent by 4 percentage points, up to 20.5 percent. That over–4-percentage-point rise in receipts as a fraction of GDP comes both from the sunset of the tax cuts of this year and 2001, but also from increases in receipts as a fraction of GDP stemming from a real bracket creep, from rising real incomes in the economy, from the influence of the alternative minimum tax, and from the taxation of funds in tax-deferred savings plans as those are withdrawn. The bulk of the 2.3 percentage points is the from sunsets. The remaining factors offer a smaller contribution to the rise over the course of the budget window.

On the outlay side, mandatory spending rises at a rate of 5.2 percent, on average, during this projection. It accelerates later in the budget window, reflecting is the leading edge of the influence of the retirement of the baby-boom population on the Federal budget. The number of, for example, enrollees in Medicare grows at 1 percentage point per year in the first 5 years but after 2008 begins to grow at a rate between 2 and 3 percentage points per year. Over the longer term, the demands of entitlement spending, even in the absence of a new prescription drug benefit in Medicare will be such that under current law, Medicare, Medicaid and Social Security will rise from 8 percent of GDP to 14 percent in 2030. That long-term pressure of entitlement spending remains a key feature of the budgetary outlook in the United States.

Finally, on the outlay side, the rate of growth of discretionary spending is assumed to be 3.1 percent. That is according to the baseline projection rules under which CBO constructs these estimates. Because that is lower than the assumed rate of growth of nominal GDP that the baseline embodies, the assumption that discretionary spending is shrinking as a fraction of GDP is a fact that should not be lost on people in interpreting the results.

The last feature, I think, that merits mention, in looking at our baseline projection, is that there is a tremendous amount of uncertainty associated with the baseline projection. There is the normal uncertainty with which CBO and many other analysts have struggled over the years that stems from attempting to see the future path of the economy, from technical adjustments to the baseline projection which reflect shifts in the relationship between the underlying economy and budgetary receipts and outlays; but in this circumstance, it also reflects a greater uncertainty about the evolution of policy. In the report, we made an attempt to provide Members with some guidance as to the possible range that one could envision due to policy uncertainty.

Now, it should be noted, there are some pieces of uncertainty that we did not attempt to quantify in the report. The most notable would be the costs of reconstruction or ongoing occupation in Iraq.

We did not have sufficient policy guidance to include those projections in the summer update. We have since, as I hope members are aware, released a bit of information about particular scenarios regarding occupation in Iraq, at the request of Senator Byrd. We did not, and were not able to quantify costs associated with energy legislation, which has assumed a new priority in the aftermath of the August blackout.

We were, however, able to quantify those areas where we did have some guidance on the nature of potential policy directions. In particular, on the receipts side, what would be the implications of keeping the tax cuts of 2001 and 2003 in place and not permitting them to sunset, and what would be the implications of fixing, in the technical sense—of not having pure inflation place people under—the alternative minimum tax? On the outlay side, we took a look at the implications of the Medicare prescription drug bill as it was embodied in the budget resolution passed by the House and Senate earlier this year and at alternative paths for the growth rate of discretionary spending.

Over the past 5 years, discretionary spending has grown at a rate of about 7.7 percent per year, on average. That rate is closely matched between defense and nondefense discretionary spending, and we tried to show the influence of a more rapid impact from, of a more rapid growth of, discretionary spending by using that historical average.

What you see, as a bottom line, is not intended as a projection or forecast in any way, but as a band of the uncertainty that these possible policies would encompass. As shown in the graph, and at the upper end, if one were to freeze discretionary appropriations, there would be a clear and more rapid return to surplus, and we would have a lower debt-to-GDP ratio than the 30 percent in the baseline.

At the other extreme, if one were to embody into the baseline projection all of the possibilities that include permanent tax cuts, fixing the AMT, a Medicare prescription drug bill and very rapid discretionary spending growth, you could see that the budget would not return to surplus. Indeed, the indicator of the fiscal sustainability, the debt-to-GDP ratio, would rise from 30 percent in the baseline out in 2013 to something like 67 percent under that particular scenario. We offer those not as particular projections, but to give you some sense of the importance of alternative choices in policy and their impact on the budget going forward.

Now, let me close—and take your questions after that—by talking a little bit about the denominator in that debt-to-GDP ratio, which I think is a good way to summarize the outlook going forward.

Our projection for the economy comes in two pieces. Over the near term, CBO attempts to produce a roughly 2-year forecast that includes the cyclical recovery that we anticipate coming in the U.S. Then over the longer term, we restrict ourselves to baseline projections of the trend rate of growth in the economy and do not attempt long-term forecasts of business cycle fluctuations.

In the former, our baseline embodies an assumption that we will have faster near-term growth, rising from 2.2 percent in calendar 2003 to 3.8 percent in 2004. The key features of the economy that will go along with that more rapid growth are a relatively slow recovery in the rate of unemployment, which will hang up in the vicinity of 6 percentage points. That reflects the net effect of two factors. As the economy grows faster, we do anticipate that more jobs will be created. That, on the one hand, would lower the unemployment rate.

At the same time, our reading of the labor force evidence is that many workers have, many more workers than is perhaps typical in a cyclical downturn, have elected not to participate in the labor force. They will be drawn back into the labor force, which will slow the decline in the unemployment rate. Inflation will remain modest in the near term, and as a result of that, there will not be great upward pressure on interest rates from an inflationary standpoint.

Over the longer term, we expect the economy to grow, on average, at a rate of 3.3 percent, between 2005 and 2008 and then to average 2.7 percent from 2009 to 2013. As this committee is well aware, the key to long-run economic growth projections is the rate of productivity growth in the economy. Our projections embody the assumption that productivity growth will continue at a rate of about 2.1 percent, a bit below the high point of the post-1995 acceleration but still very healthy productivity growth in the U.S. economy.

The diminished rate of overall GDP growth comes as a reflection of, again, the baby-boom population beginning to withdraw from the labor force and a slower growth in the number of workers available for production. And, as a result, the combination of robust productivity growth, and a slower growth in the labor force will lead to a bit slower long-run GDP growth.

In closing, I want to note that our projections attempt to include the impacts of the fiscal policies that are in place in the budget projections. In particular, we take into account, in our long-run projections, the impact of the baseline spending on deficits and, thus, on pressure on credit markets, higher interest rates, and any diminished investment that might result.

We, in the same way, on the receipts side, take into account the incentive effects of the tax cuts, which would increase labor supply and incentives to save, as well as the crowding-out effects that come from the deficits associated with the tax side.

The net effect is a modest negative. But if you read through the detailed discussion of that, in Chapter 2, what you will see is that to do such a projection requires us to struggle with a very tough analytic problem, quite frankly.

The behavior of the economy will depend primarily on how the private sector views the fiscal policies. In particular, will the tax cuts be made permanent or not, or will some features of the tax cut be made permanent or not? We, quite frankly, do not know, in any precise way, what the private-sector believes about the future of that fiscal policy. We have constructed our projections, in the spirit of baseline projections, by assuming that private-sector agents will, in fact, believe that the sunsets occur on schedule and believe that the discretionary spending will grow as in the baseline. In fact, expectations could differ greatly, and the actual impacts would differ as a result.

This problem with trying to discern what the private sector thinks about the future path of policy shows up not only in the economics, but it is also difficult in doing the baseline projections themselves. For example, in the face of a sunset, there are clear incentives to shift tax activities across years. That will affect our baseline receipts on a year-to-year basis, and the usual problems associated with doing baseline projections of revenues are, in fact, much more complicated in this setting.

So it is important to keep that in mind, that the underlying baseline policy adds to the uncertainty associated with our projections at this point in time, and we have made a good-faith effort to get both the economics and the budget projections correct in that context.

So, with that as the highlights, I think the key messages are associated with the nature of baseline projections and the uncertainties. I would be happy to take your questions.

[The prepared statement of Mr. Holtz-Eakin follows:]

CBO TESTIMONY

Statement of
Douglas Holtz-Eakin
Director

The Budget and Economic Outlook: An Update

before the
Committee on the Budget
United States Senate

September 3, 2003

This statement is embargoed until 10:00 a.m. (EDT) on Wednesday, September 3, 2003. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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

Mr. Chairman, Senator Conrad, and Members of the Committee, I am pleased to be here today to discuss the Congressional Budget Office's (CBO's) update of its baseline budget projections for 2003 through 2013. CBO projects that the federal government will incur deficits of $401 billion in 2003 and $480 billion in 2004 under the assumption (mandated by statute) that current laws and policies remain the same (*see Table 1 on page 5*). Those deficits reflect the recent economic slowdown as well as legislation enacted over the past few years that has reduced revenues and rapidly increased spending for defense and many other programs. Although such deficits for this year and next year would be smaller than those of the mid-1980s relative to the size of the economy, they would reach record levels in nominal dollar terms.

The economy now seems poised for a more sustained recovery. CBO anticipates that gross domestic product (GDP) will rise by nearly 4 percent in calendar year 2004 after growing by less than 2 percent in the first half of this year. Signs of faster growth in consumer and business spending, rapid growth in federal purchases, tax cuts for businesses, and a slightly more accommodative monetary policy have improved the economic outlook for the rest of 2003 and for 2004.

Partly because of that economic growth, CBO's baseline projections show deficits that diminish and then give way to surpluses near the end of the 2004-2013 period—under the assumption that no policy changes occur. In particular, the baseline assumes that the major tax provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) will expire as scheduled in 2010. It also assumes (as required by the Balanced Budget and Emergency Deficit Control Act of 1985) that budget authority for discretionary programs will grow at the rate of inflation—which is projected to average 2.7 percent over the next 10 years. Furthermore, the baseline does not include possible policy changes such as the introduction of a prescription drug benefit for Medicare beneficiaries. Various combinations of possible actions could easily lead to a prolonged period of budget deficits, although other scenarios could be more favorable. In addition, economic and other factors that deviate from CBO's assumptions could affect the budget considerably—in either a positive or a negative direction.

Regardless of the precise course of the economy and future policy actions, significant long-term strains on spending will begin to intensify within the next decade as the baby-boom generation begins reaching retirement age. Driving those pressures on the budget will be growth in the largest retirement and health programs—Social Security, Medicare, and Medicaid. Federal spending on those three programs will consume a growing proportion of budgetary resources, rising as a share of the economy from 8 percent in 2002 to a projected level of nearly 14 percent in 2030.

The Budget Outlook

CBO projects that if current laws and policies remain unchanged, the recent surge in federal budget deficits will peak in 2004. In the ensuing years, under CBO's baseline, deficits decline steadily and give way to surpluses near the end of the 10-year projection period. Deficits are projected to total $1.4 trillion between 2004 and 2008; the following five years show a small net surplus of less than $50 billion.

Revenues have slid from a peak of 20.8 percent of GDP in 2000 to 16.5 percent this year and are anticipated to drop again next year, to 16.2 percent. From that point on, the trend reverses, as projected economic growth pushes revenues in the baseline up from 17.4 percent of GDP in 2005 to 18.7 percent in 2010. Under current laws and policies, revenues are projected to climb more rapidly thereafter because of the expiration of EGTRRA, reaching 20.5 percent of GDP in 2013.

Whereas revenues are expected to diminish in 2003, CBO anticipates that total outlays will rise—from 19.5 percent of GDP in 2002 to 20.2 percent this year. Under the assumptions of CBO's baseline, outlays are projected to peak at 20.5 percent of GDP in 2004 and then to begin a gradual decline as a share of the economy. By 2013, outlays are projected to account for 19.3 percent of GDP. That decline is mostly attributable to the baseline's treatment of discretionary spending, which is assumed to grow at the rate of inflation over the projection period (or at about half the rate of growth projected for the economy).

Since CBO last issued baseline projections in March, the budget outlook has worsened substantially. Half a year ago, CBO estimated that the deficit for 2003 would total $246 billion, the deficit for 2004 would decline slightly to $200 billion, and the cumulative total for the 2004-2013 period would be a surplus of $891 billion. Now, CBO's estimate for this year's deficit has risen by $155 billion and for next year's by $280 billion. For the 10- year period from 2004 through 2013, projected deficits have increased and projected surpluses have decreased by a total of nearly $2.3 trillion (*see Table 2 on page 6*).

Compared with the projections in the March baseline, revenues have declined by $122 billion for 2003 and by $878 billion for the 2004-2013 period. Changes resulting from legislation, mostly the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), account for the majority of the decline through 2005. After that, technical estimating changes explain most of the drop in projected revenues relative to those in the March baseline.

Outlays are $33 billion higher for 2003 than previously projected and a total of $1.4 trillion higher over the 10- year period, largely because of legislation enacted since March. Extending supplemental appropriations enacted in April and August over the 2004-2013 period, as required for CBO's baseline projections, accounts for $873 billion of that total, and additional debt-service costs resulting from both tax and spending legislation account for most of the rest.

The Economic Outlook

CBO's forecast for the next year and a half anticipates that the growth in overall demand for goods, services, and structures will pick up. The growth of consumer spending will remain modest because consumers are likely to save much of the money that they receive from the accelerated tax cuts under JGTRRA to rebuild their wealth. Businesses are likely to begin to restock, rather than draw down, their inventories and to increase their investments in structures and equipment. As a result, real (inflation-adjusted) GDP is expected to grow by 3.8 percent in calendar year 2004, up from 2.2 percent in 2003 (*see Table 3 on page 7*). CBO's forecast assumes that the rapid rise in the federal government's spending will contribute to growth for the next few quarters, but thereafter, under the assumptions in CBO's baseline, such growth will slow.

CBO does not anticipate a quick reduction in the unemployment rate from its current level. Typically, the unemployment rate falls when the growth of real GDP exceeds the growth of potential GDP (the highest level of production that can persist for a substantial period without raising inflation). But even though the GDP growth that CBO is forecasting exceeds its estimate of potential GDP, CBO expects that the unemployment rate will average 6.2 percent for calendar years 2003 and 2004. In part, the sustained high rate of unemployment reflects caution on the part of employers, who—if they follow recent patterns—are not likely to resume hiring immediately as demand begins to grow. In part, it also reflects the likelihood that people who have been discouraged in their job searches by the economic weakness of the past few years are now likely to resume them—and be tallied among the unemployed.

The near-term outlook is subject to a number of risks. Foreign economic growth and foreign demand for U.S. goods may deviate from the assumptions in CBO's forecast. The residual effects of certain economic developments in recent years—the large reduction in households' equity wealth, the fall in the personal saving rate, businesses' productive capacity that remains underused, and the increased dependence on foreign financing—may also continue to dampen growth more than CBO assumes. However, favorable economic fundamentals—such as low inflation and rapid growth of productivity—may set the stage for another long period of robust growth.

Between 2005 and 2008, the growth of real GDP is projected to average 3.3 percent, and between 2009 and 2013, 2.7 percent. In CBO's projections, the growth of real GDP slows as the gap closes between GDP and its potential; once that gap has been eliminated, real GDP grows at the same rate as potential GDP.

CBO expects that inflation, as measured by the consumer price index for all urban consumers, will average 2.5 percent from 2005 through 2013, while the rate of unemployment will average 5.3 percent. The projection for the rate on three-month Treasury bills averages 4.6 percent during the 2005-2013 period and that for 10-year Treasury notes, 5.8 percent. All of those projections are virtually identical to the ones published by CBO last January.

Table 1.

Projected Deficits and Surpluses in CBO's Baseline

(In billions of dollars)

	Actual 2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
On-Budget Deficit (-)	-317	-562	-644	-520	-425	-421	-434	-426	-417	-298	-143	-105	-2,444	-3,833
Off-Budget Surplus[a]	160	162	164	179	199	219	237	255	273	289	304	317	999	2,436
Total Deficit (-) or Surplus	**-158**	**-401**	**-480**	**-341**	**-225**	**-203**	**-197**	**-170**	**-145**	**-9**	**161**	**211**	**-1,445**	**-1,397**

Source: Congressional Budget Office.

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

Table 2.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since March 2003

(In billions of dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
Total Deficit (-) or Surplus as Projected in March 2003	-246	-200	-123	-57	-9	27	61	96	231	405	459	-362	891
Changes													
Legislative													
Revenues	-53	-135	-77	-20	-13	-17	-11	-4	4	2	2	-263	-270
Outlays	46	92	101	105	117	129	140	150	162	172	184	544	1,352
Subtotal	-99	-227	-178	-126	-130	-146	-151	-155	-158	-169	-183	-808	-1,622
Economic													
Revenues	-16	-13	-12	-12	-15	-17	-19	-23	-20	-12	-8	-70	-151
Outlays	*	-12	-31	-34	-25	-16	-16	-17	-20	-24	-28	-118	-223
Subtotal	-16	-1	18	21	10	*	-3	-6	*	11	21	48	72
Technical													
Revenues	-53	-51	-51	-51	-55	-50	-45	-41	-39	-40	-34	-258	-457
Outlays	-13	1	6	12	19	27	33	39	44	47	51	66	280
Subtotal	-40	-51	-58	-64	-74	-77	-78	-80	-82	-87	-86	-324	-737
Total Impact on the Deficit or Surplus	**-155**	**-280**	**-218**	**-168**	**-194**	**-223**	**-232**	**-240**	**-240**	**-245**	**-248**	**-1,083**	**-2,287**
Total Deficit (-) or Surplus as Projected in August 2003	-401	-480	-341	-225	-203	-197	-170	-145	-9	161	211	-1,445	-1,397
Memorandum: Legislative Changes to Discretionary Outlays													
Defense	27	54	62	65	66	68	70	72	74	75	77	315	683
Nondefense	6	14	17	18	19	19	20	20	21	21	22	87	190
Total	33	68	79	83	85	87	90	92	95	96	99	402	873

Source: Congressional Budget Office.

Note: * = between -$500 million and $500 million.

Table 3.

CBO's Current and Previous Economic Projections for Calendar Years 2003 Through 2013

	Forecast		Projected Annual Average	
	2003	2004	2005-2008	2009-2013
Nominal GDP (Billions of dollars)				
August	10,836	11,406	14,098[a]	17,943[b]
January	10,880	11,465	14,154[a]	18,066[b]
Nominal GDP (Percentage change)				
August	3.7	5.3	5.4	4.9
January	4.2	5.4	5.4	5.0
Real GDP (Percentage change)				
August	2.2	3.8	3.3	2.7
January	2.5	3.6	3.2	2.7
GDP Price Index (Percentage change)				
August	1.5	1.4	2.1	2.2
January	1.6	1.7	2.1	2.2
Consumer Price Index[c] (Percentage change)				
August	2.3	1.9	2.5	2.5
January	2.3	2.2	2.5	2.5
Unemployment Rate (Percent)				
August	6.2	6.2	5.4	5.2
January	5.9	5.7	5.3	5.2
Three-Month Treasury Bill Rate (Percent)				
August	1.0	1.7	4.2	4.9
January	1.4	3.5	4.9	4.9
Ten-Year Treasury Note Rate (Percent)				
August	4.0	4.6	5.7	5.8
January	4.4	5.2	5.8	5.8

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

Note: Percentage changes are year over year.

a. Level in 2008.

b. Level in 2013.

c. The consumer price index for all urban consumers.

Projected Deficits and Surpluses in CBO's Baseline
(In billions of dollars)

	Actual 2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
On-Budget Deficit (-)	-317	-562	-644	-520	-425	-421	-434	-426	-417	-298	-143	-105	-2,444	-3,833
Off-Budget Surplus	160	162	164	179	199	219	237	255	273	289	304	317	999	2,436
Total Deficit (-) or Surplus	-158	-401	-480	-341	-225	-203	-197	-170	-145	-9	161	211	-1,445	-1,397
Total Deficit (-) or Surplus as a Percentage of GDP	-1.5	-3.7	-4.3	-2.9	-1.8	-1.5	-1.4	-1.2	-0.9	-0.1	1.0	1.2	-2.3	-1.0
Debt Held by the Public as a Percentage of GDP	34.2	37.1	39.5	40.4	40.1	39.7	39.2	38.5	37.6	36.0	33.4	30.7	n.a.	n.a.

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Changes in CBO's Baseline Projections of the Deficit Since March 2003 (In billions of dollars)

	2003	2004	2005
Total Deficit as Projected in March 2003	-246	-200	-123
Changes			
Legislative			
Revenues	-53	-135	-77
Outlays	46	92	101
Subtotal	-99	-227	-178
Economic and Technical			
Revenues	-69	-64	-64
Outlays	-13	-11	-24
Subtotal	-56	-52	-39
Total Impact on the Deficit	-155	-280	-218
Total Deficit as Projected in August 2003	-401	-480	-341

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CBO's Economic Projections for Calendar Years 2003 Through 2013

	Actual	Forecast		Projected Annual Average	
	2002	2003	2004	2005-2008	2009-2013
Nominal GDP (Billions of dollars)	10,446	10,836	11,406	14,098	17,943
Nominal GDP (Percentage change)	3.6	3.7	5.3	5.4	4.9
Real GDP (Percentage change)	2.4	2.2	3.8	3.3	2.7
GDP Price Index (Percentage change)	1.1	1.5	1.4	2.1	2.2
Consumer Price Index (Percentage change)	1.6	2.3	1.9	2.5	2.5
Unemployment Rate (Percent)	5.8	6.2	6.2	5.4	5.2
Three-Month Treasury Bill Rate (Percent)	1.6	1.0	1.7	4.2	4.9
Ten-Year Treasury Note Rate (Percent)	4.6	4.0	4.6	5.7	5.8
Tax Bases (Percentage of GDP)					
Corporate book profits	6.4	6.8	7.0	9.6	8.4
Wages and salaries	47.8	47.3	47.3	47.4	47.4
Tax Bases (Billions of dollars)					
Corporate book profits	665	742	797	1,261	1,503
Wages and salaries	4,996	5,128	5,394	6,685	8,518

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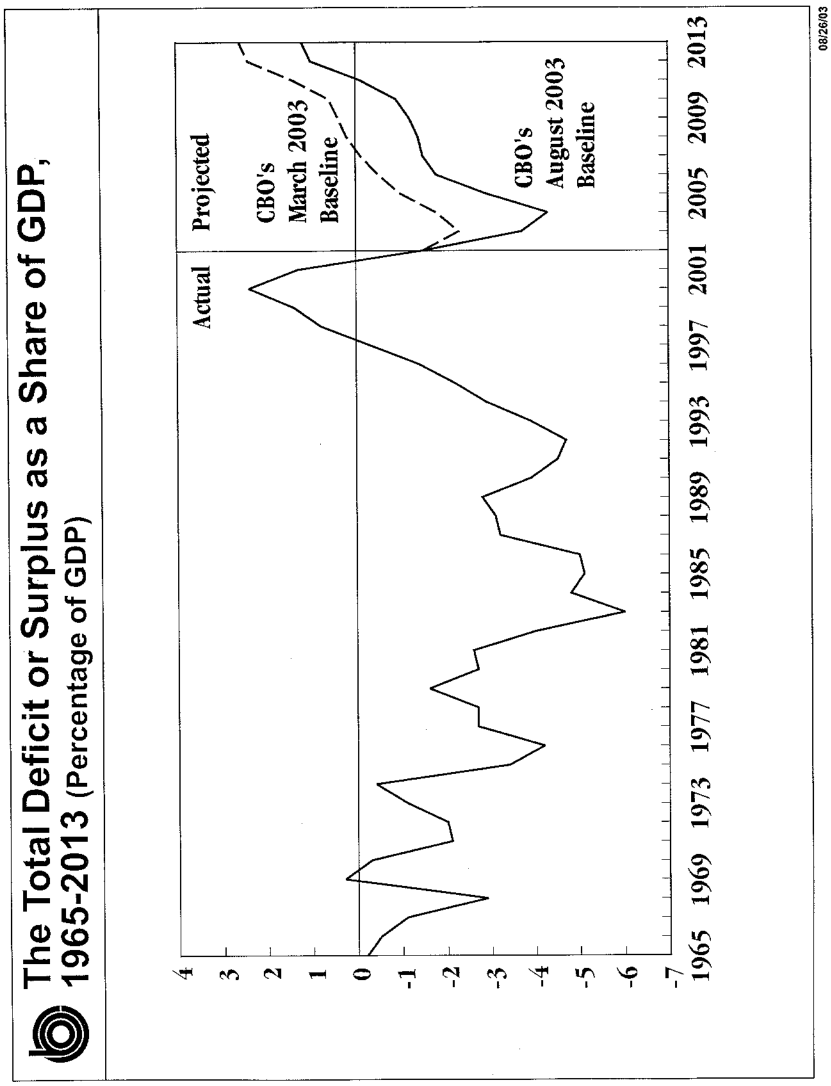
The Total Deficit or Surplus as a Share of GDP, 1965-2013 (Percentage of GDP)
Actual
Projected
CBO's March 2003 Baseline
CBO's August 2003 Baseline
4
3
2
1
0
-1
-2
-3
-4
-5
-6
-7
1965
1969
1973
1977
1981
1985
1989
1993
1997
2001
2005
2009
2013
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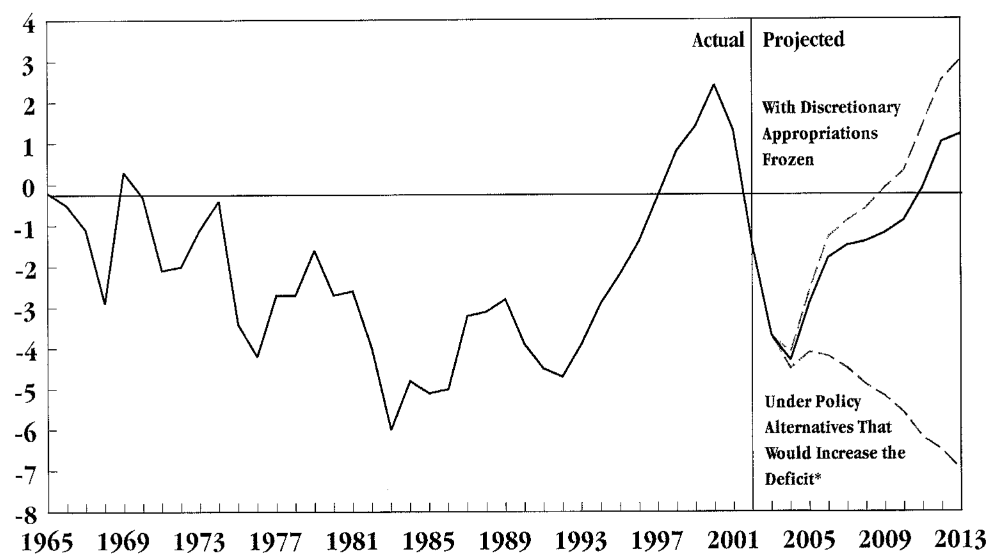
The Budgetary Effects of Policy Alternatives Not Included in CBO's Baseline (Percentage of GDP)



* Increasing discretionary appropriations by 7.7 percent a year, extending expiring tax provisions, reforming the alternative minimum tax, and reforming Medicare to include a prescription drug benefit.

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Chairman NICKLES. Director Holtz-Eakin, thank you very much for your presentation. I notice our colleagues are here. I will defer any questions at this point. I have some, but I would like to give our colleagues a chance.

Senator CONRAD. I have a few questions, if I could.

First of all, thank you for that presentation—very professional and very clear.

You know, we go to the point of uncertainty. You indicated there is great uncertainty looking forward, and you have given reasons for that uncertainty. Let me just go back to 2 years ago when CBO produced a similar fan chart of potential uncertainty. You will recall at the time you adopted—CBO adopted, you were not there—the midpoint of the range telling us, and telling the country, that we were going to have $5.6 trillion of surpluses. I think it is useful to go back and fit what has really happened. What we see is the red line. What that shows us is we are below the bottom of what was projected just 2 years ago, with respect to what the deficits would be, and quite far below the bottom.

Let me go to the next chart. This is from the Washington Post. I do not know if you saw Alan Sloan's column of yesterday in the Washington Post. Alan Sloan said that after adjustment for political reality, deficit projections get scary. What he has done is he took your baseline numbers, and then instead of using Social Security to offset the cash shortfall, he set that aside. So he started with, here, $1.4 trillion. He then set Social Security aside, $2.4 trillion over the 10 years. Then, he added in what the President has proposed and what is in our budget for $400 billion for prescription drugs because that is not in your baseline; is that correct?

Mr. HOLTZ-EAKIN. That is correct.

Senator CONRAD. Because that has not happened, so you cannot put it in your baseline.

He then put in $400 billion for fixing the alternative minimum tax, which by the end of this decade is going to affect $30 million American people unless we do something. Then he extended the tax cuts, and I think he had $2.8 trillion there, and he added that all up. Instead of $1.4 trillion of deficits, he had, on an operating basis, $7.4 trillion of deficits over this period of time.

While $1.4 trillion is daunting, $7.4 trillion, which he asserts is more realistic in terms of what will actually happen, is truly stunning. Just 2 years ago, we were told we are going to have $5.6 trillion of surpluses over the next 10 years. Now, we are talking about $7.4 trillion of deficits.

The first question I have for you in this Sloan calculation, are there any elements of that with which you disagree, in terms of the numbers?

Mr. HOLTZ-EAKIN. I think the numbers strike me as reasonable. I will not pretend to have done a detailed analysis of Mr. Sloan's column.

Senator CONRAD. Well, I would ask you to take a look a that when you have more time and just to tell me whether or not you think those numbers are roughly accurate because it tells me that we are on a course here that is utterly unsustainable, especially given the fact the baby boomers are about to retire. You know, this is all happening at what I call the worst possible time.

If, in fact, we face deficits of that magnitude, $7.4 trillion over the next 10 years, what would your advice be to this committee and to the Congress on fiscal policy?

Mr. HOLTZ-EAKIN. It, as you well know, is not the role of the CBO Director to offer up specific policy advice. I think that, in looking at the impact of deficits on the economy, one really needs to focus on the fact that deficits represent, on net, a diminishment of national saving. There are circumstances in which shifting from saving to spending can prove beneficial. Indeed, in times of economic slack, this is widely recognized as one of the things that can support an economy and, if done with appropriate discretion, timing, and skill may even be beneficial.

Going forward, in an economy that has reached full employment, that has achieved its capacity utilization, that additional spending places a strain on the economy. The symptom of that strain is typically higher interest rates or greater capital inflows, and that, other things equal, will slow the accumulation of capital, in both its physical and human forms, and reduce the rate of overall economic growth and the pace at which the economy will expand. That is the ultimate tradeoff in examining the impacts of policies that might increase the deficit—are the gains in the near term sufficient to outweigh those particular costs?

Senator CONRAD. Let me just say, and I would say to my colleague, the chairman, with respect to his opening statement, I did not quarrel with having tax cuts in the near term. In fact, I proposed bigger tax cuts than the President proposed, in the near term, to give lift to the economy. The great concern I have is the combination of tax cuts that go on into the future, that explode in costs at the very time the cost of the Federal Government explodes because of the retirement of the baby-boom generation is taking us toward a fiscal cliff. I think it is just as clear as it can be, and it is utterly unsustainable, and we have to change course.

Does that mean tax increases? No. I do not think tax increases would be a wise thing with the economy weak. I think that would be counterproductive. I do think we have to look on the revenue side of the equation down the road, and I think the first place to look ought to be the over $200 billion a year that is owed that is not being paid. That is truly stunning, a tax gap. The difference between what is owed and what is being paid, the vast majority of people pay what they owe.

Have you done any estimates on the tax gap that are more recent than those numbers which are now some 4 years old?

Mr. HOLTZ-EAKIN. No, we do not have any recent estimates, but we would be happy to work with you if it was a topic that you wanted to pursue.

Senator CONRAD. I would ask that you do an estimate for me, and the chairman might join me for the committee——

Chairman NICKLES. Certainly.

Senator CONRAD [continuing]. On the difference between what is owed and what is being paid because I think that is something we are going to have to look at very closely.

Mr. HOLTZ-EAKIN. Happy to do that.

Senator CONRAD. I thank you.

Chairman NICKLES. Senator Conrad, thank you very much, and I appreciate those comments.

Senator Crapo.

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

Dr. Holtz-Eakin, I wanted to go back with you and your discussion about Chapter 2 of the report. Primarily, if I understand you or understood your testimony correctly, you were talking about the potential for doing what I call dynamic scoring; is that right? You were talking about the difficulty of trying to understand what the impact on the economy truly would be of the tax relief, and the spending, and how those who operate in the economy will view those.

Mr. HOLTZ-EAKIN. I would choose a different term, quite frankly. Dynamic scoring is typically associated with scoring a particular bill or piece of legislation. What we were trying to do was the best baseline projection, which involves, I understand, the impact of policies in place, as these are on the future path of the economy. It is, at an analytic level, very similar. You have to find out how the policies will influence the future path of the economy, and what we try to do is outline our thinking and the different dimensions on the policy front.

Senator CRAPO. So, although I may be using the term differently than you do, does the Budget Committee, as it makes these projections, actually try to determine what the impact of, say, the extension of the tax relief would be on the economy, in terms of increased economic activity or decreased economic activity and then build that into the budget projections?

Mr. HOLTZ-EAKIN. Indeed, we tried to place in our baseline projection, in particular, the impact of the sunset of the 2001 tax cuts at the end of 2010, and show the impacts on labor supply, which in this case would be negative, as well as all of the other possible impacts of the many policies in place. So you see the net effect of all of the spending and all of the tax policies in our projection.

Senator CRAPO. So, for example, on Page 12 of the report, you have some of the alternative policy options that Congress could adopt, and you have projected out what those impacts would be if Congress did adopt them; for example, if Congress extended the expiring tax provisions or adopted a prescription drug benefit and so forth.

Just taking the tax provisions, there is a number there that you have for each of the years, and then a total for the 10-year period. Does that number simply total up the expected fiscal impact of the lost revenue to the Federal Government or does it also include projections of what might occur, in terms of increased revenue to the Government, from increased economic activity, if the tax policy were correctly implemented?

Mr. HOLTZ-EAKIN. It is a static estimate of the budget costs built on our baseline economic projection. We did not include any feedbacks from particular entries in Table 1–6 on the underlying economy.

Senator CRAPO. Would it not be more accurate to try to project those kinds of impacts? Let me ask the question this way: Would it not be correct to say that if we have an extension of the expiring tax provisions, for example, that that would have an impact on economic activity in this country and generate an increase in revenue in other taxation?

Mr. HOLTZ-EAKIN. There is no question that if that were the baseline policy, we would estimate our underlying path of the economy differently. The net effect of the incentives from lower marginal tax rates, the incentives to consume from tax credits, for example, and from the overall deficit or surplus is not clear, but certainly you would want to take all of those considerations into account when doing the projection.

Senator CRAPO. But you have not done that in this chart.

Mr. HOLTZ-EAKIN. No.

Senator CRAPO. I guess my question is would it not be much more accurate to do that?

Mr. HOLTZ-EAKIN. It would be perhaps more accurate, but the spirit of the chart is to allow people to rank things in a very technical projection sense. We know the ordering of things because they are done on a level basis with the same underlying economy. So we thought that that clarity was outweighed by the virtues of doing a more particular forecast. As a computational matter, it is quite difficult to do this once in the baseline. To do every line in that table would have extended the project somewhat.

Senator CRAPO. I understand that. In fact, my next question was going to be, if we decided to try to do it, and that is where I call it dynamic scoring, if we tried to do dynamic scoring of something like extending the tax cut or adopting a prescription drug benefit, is it doable?

Mr. HOLTZ-EAKIN. It is doable. The questions are really at the practical level: Is it doable in a timely fashion, in the legislative process? Is it doable with sufficient understanding to be useful to the Members? Can we get well enough specified policies to actually implement it? It requires one of the advantages of baseline policies, which is that we know them down to the last detail, whereas proposals are often less detailed and harder to implement. But, in principle, one could do this kind of analysis on any particular proposal.

Senator CRAPO. All right. Just one last question, and that is you mentioned that the impact on the labor market or the labor supply would be negligible. Was that the impact of extending the tax cuts or the impact of allowing the tax cuts to expire?

Mr. HOLTZ-EAKIN. As it is mentioned in our report, the impact of allowing the tax cuts to expire, having higher marginal tax rates, has a negative impact on labor supply, although the size of that impact is small relative to the kinds of uncertainty associated with just going out 10 years in an economic projection.

Senator CRAPO. That is another aspect of this dynamic scoring that I am talking about, is it not? If we do allow the tax cuts to expire, and that has a negative impact on the labor supply, then that, in itself, will then play into the deficit numbers in some way.

Mr. HOLTZ-EAKIN. Yes, but the deficit numbers will ultimately reflect all of the influences of the policy not just any one particular piece, and we would have to work through that.

Senator CRAPO. Understood. All right. Thank you very much.

Thank you, Mr. Chairman.

Chairman NICKLES. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman, and, Director, for a very informative presentation.

I am awestruck, frankly, by the negative cash-flow that we have experienced relative to what people think. Seven trillion dollars between the 2001 and, using your baseline number, and if I use this bottom-line number on your last chart that you presented to us, where we get to 67 percent of debt-to-GDP, that would be a $13-trillion cash-flow, negative cash-flow, swing in two/three years. I do not know anyone who would, you know, I would be hard to find anyone considering that sound fiscal policy.

I know it is not your issue to comment on, but I think it puts us in a devastated fiscal situation. If I read the assumptions that you are putting in, which really ties into the Sloan article that Senator Conrad spoke about, reforming Medicare with a prescription drug benefit, alternative minimum tax and expiring tax provisions with some allowance for discretionary spending on defense, whether it is missile shield or boutique nuclear weapons or increased force structure, those things seem like probabilities that are something north of 50 percent, if you were going to assign probabilities, and I just wonder if you think moving to a GDP or debt-to-GDP of 67 percent is one that is going to have the kind of impact you are all projecting on interest payments and level of interest rates, that I see in these projections, we are talking about really still fairly historic low interest rates, 2005–2008, interest payments which actually are going to get close to what we are spending on discretionary domestic spending anyway if we follow along the paths we are.

I wonder if those are realistic assumptions in the context of the assumptions that could be made with regard to the spending that we think is likely to occur on defense, Medicare prescription drugs, AMT adjustment.

Mr. HOLTZ-EAKIN. The interest rate and other assumptions in the economic projection are built on the baseline budget projections. They do not, in fact, reflect the various alternatives that are in that table. It is the same issue that arose earlier. We believe that the interest rate assumptions in our economic projection are consistent with the baseline budget, but they do not attempt to accommodate all possible ranges of budgetary outcomes.

Senator CORZINE. Would you care to make any guess of what would happen if we actually went to debt-to-GDP of 67 percent? Would that impact interest payments in a context of dynamic scoring?

Mr. HOLTZ-EAKIN. I think you would want to distinguish between two things. The first is a consistent, steady, high debt-to-GDP ratio as, for example, other countries have had, where you would have, at the same interest rates, higher interest payments on the Federal budget, no question.

The second is whether you believe that the debt-to-GDP ratio has stabilized or is continuing to rise. If markets recognize a fiscal policy that is not stable and shows an ever-rising debt-to-GDP ratio, you would expect much sharper increases in interest rates.

Senator CORZINE. You certainly would associate that with the bottom end of the projection that you had in your chart, I would presume.

Mr. HOLTZ-EAKIN. Yes.

Senator CORZINE. That would lead to real competition in capital markets, the Federal Government competing with the private sector for capital and would undoubtedly weaken economic growth relatively substantially, I would suspect, the kind of thing that we saw in the eighties, as we saw our budget deficits balloon.

Mr. HOLTZ-EAKIN. The projections in that particular scenario, which again represent a particular combination that may not have any special features, but the numbers in there are, in fact, much larger than what we experienced in the eighties. The deficit as a fraction of GDP is larger than the 6 percent, which was the highest in the eighties, and the average was much lower. So that would have substantial impacts, one would expect, on capital markets and on the capital accumulation in the economy.

Senator CORZINE. Have you happened to calculate, and I would like actually to see this, what the debt burden per individual would be under baseline projections and maybe your two other projections that you show on the fan? How much does each individual end up having responsibility for and, using your assumptions on what interest rates would be, what the debt tax is for each individual?

Mr. HOLTZ-EAKIN. We would be happy to work through it and get you that number. I do not actually have it with me.

Senator CORZINE. I think those things would be interesting to understand how each individual is, in the U.S., is taking on a responsibility, a financial responsibility to fund the kind of deficits that we are running.

Thank you.

Chairman NICKLES. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I would just like to followup on a letter that the chairman had sent out requesting an analysis of the tanker aircraft study. I serve on Armed Services, and we will have a hearing on that tomorrow, and there might be a hearing on it today.

I would just like to have, for the record, your comments on how the Air Force's lease proposal compares to a direct purchase of the tanker aircraft.

Mr. HOLTZ-EAKIN. Our analysis shows that the particular financing arrangement in the Air Force proposal would, in fact, deliver the same planes on the same schedule at a higher cost than would buying the planes through the appropriations process. Over the life of the lease, it would be a difference of about $5.7 billion.

Senator ALLARD. Now, would you talk a little bit on the uniqueness of that proposal. They have, in my looking at it, they have set aside a special purpose fund or trust. There are bonds that are sold to bring money into that fund. It is also there is a loan provision in there, and then the expenditure goes out. What implication does that have over the oversight of this committee and Congress in general?

Mr. HOLTZ-EAKIN. I think, if you read through our report, there are two features that they are mentioning in that regard.

The first is that the trust that would be set up would, in fact, issue bonds. It would also engage in some construction financing, and it would purchase the planes from Boeing. The trust itself would exist solely for the purpose of borrowing and making those purchases, and it would, in fact, be controlled by the Air Force. From that perspective, it is clearly a governmental activity and ought to be reflected in the Government's budget, with interest payments reflected in the usual outlay stream and purchases of planes in the usual outlay stream and all transactions between the Government and the trust as intergovernmental transfers. It is our view that this is best viewed as an activity of the Government that should be in the budget.

To the extent that one sets the precedent of allowing this kind of special financing arrangement to go forward, it does, in fact, allow projects to be given a greater priority, through an apparent cheapness on the budget. This makes the cost of those airplanes appear to occur largely in the end years of the life of the lease; it"back-loads" the cost in some budgetary sense. That is a misleading impression, in our view, of the true way that should be budgeted, since our view is that the goal of the budget should be to present policymakers with the various proposals on a level playing field so that those projects that merit priority on policy grounds receive it. To the extent that projects get to move up just by arranging this kind of a financing scheme, that would be at odds with what we view as the objective of presenting the budget in a clear and level fashion.

Senator ALLARD. You are viewing this as a lease purchase.

Mr. HOLTZ-EAKIN. We believe it is best viewed as a purchase of these aircraft. If one did manage to draw the conclusion that the activities of the trust were not, in fact, governmental activities, which is not an opinion we share, but if one drew the opinion that that was outside the boundaries of the Government, it is still difficult to believe that this is an operating lease for these very specialized aircraft. So the transaction should be put in the budget as a lease-purchase.

Senator ALLARD. Yes. Lease purchases traditionally get treated as the expenditure occurs at that particular point in time that the agreement is entered into.

Mr. HOLTZ-EAKIN. In contrast to the operating——

Senator ALLARD. I think I have been involved in some of that before, and so this looks to me like kind of a different animal than what we have had ever had to deal with as far as accountability.

And so when they, what is your understanding, when they sell those bonds, I mean, when you sell bonds out on the market, there is some assurance that there will be revenue coming in somewhere, and where is that, your understanding, where is the assurance that that revenue will come from?

Mr. HOLTZ-EAKIN. The Air Force report to Congress discusses this. Reports in the press indicate that there will be three kinds of bonds issued. Two of those would be retired using the lease payments from the Air Force to the trust. The third would depend upon the ultimate sale of the aircraft to the Air Force and, as a result, the underlying source of the credit-worthiness of these is the flow of resources from the Air Force to the trust.

Senator ALLARD. But there is some assumption there that there will be a flow of resources from the Congress during these years in the budget process; is there not?

Mr. HOLTZ-EAKIN. Indeed, yes.

Senator ALLARD. I mean, that has a budgeting impact. If, for some reason, the dollars do not come, then they began to have an impact on our budget; is that correct?

Mr. HOLTZ-EAKIN. Ultimately, these are purchases of aircraft. Boeing receives $131 million per aircraft, on average, and the Air Force pays $161 million, on average, through the trust in order to acquire them. Those resources will have to come from the U.S. budget.

Senator ALLARD. Can you ever recall when we've had this type of budgetary mechanism used to finance any type of capital investment like that?

Mr. HOLTZ-EAKIN. My tenure as CBO Director makes me the worst study in this room, quite likely, but it is, upon analysis, inconsistent with both broad Federal budgeting principles and with precedence for what constitutes an operating lease.

Senator ALLARD. Well, I assume, though, that you spent some time looking it up, as though we have ever done this before, and the simple answer is, no, we have never done this before; is that correct?

Mr. HOLTZ-EAKIN. Not to my knowledge.

Chairman NICKLES. Senator Allard, thank you.

I am going to take a little time as chairman. I did not ask any questions, but this is one that I was going to raise. It is one that I sent a letter to the Director asking.

Let me ask you just to kind of paraphrase a couple of things. The net present value of the cost of purchase is $131 million and lease would be $161 million?

Mr. HOLTZ-EAKIN. That is not a present value, but if you look at the flow of financing, as we understand the arrangement, Boeing would get an average of $131 million in constant dollars, so ignore inflation. But it would get an average of $131 million for each plane.

The Air Force would pay, in total, for lease payments plus purchase at the end of the lease, $161 million. The difference can be ascribed to the particular financing arrangement that requires payment of interest to bondholders and also construction financing.

Chairman NICKLES. No, Boeing would not get more money, but the cost of the—or would they?

Mr. HOLTZ-EAKIN. Boeing would, if one compared this particular arrangement with simply appropriating budget authority and purchasing the airplanes, Boeing would get the same. It would simply be less costly for the taxpayer.

Chairman NICKLES. The taxpayers would end up paying more because the financing mechanism is not the same.

Mr. HOLTZ-EAKIN. Yes.

Chairman NICKLES. Your letter to me states, and I will include this in the record, "CBO analysis of the proposed arrangements would cost between $1.3 billion and $2 billion more in present-value terms or 10 to 15 percent more than an outright purchase"; is that correct?

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Douglas Holtz-Eakin, Director

August 26, 2003

Honorable Don Nickles
Chairman
Committee on the Budget
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

As you requested in your letter of July 14, 2003, the Congressional Budget Office (CBO) has reviewed the Air Force's report on its plan to lease 100 Boeing KC-767A aerial refueling aircraft. In that report, submitted to the Congress on July 11, 2003, the Air Force concluded that its plan to acquire the aircraft using a leasing arrangement would cost about $150 million more (expressed in net-present-value terms) than an outright purchase. According to the report, the proposed leasing arrangement meets all requirements of the Department of Defense Appropriations Act, 2002, including criteria for an operating lease specified in the Office of Management and Budget's (OMB's) Circular A-11, *Preparation, Submission, and Execution of the Budget* and leasing is the preferred approach because of the "advantage it affords for quickly delivering needed tankers to our warfighters without requiring significant up-front funding."

After analyzing the Air Force's report and receiving additional information about the proposed lease from the Air Force and Boeing, CBO has concluded that the proposed transaction would essentially be a purchase of the tankers by the federal government but at a cost greater than would be incurred under the normal appropriation and procurement process. The special-purpose entity that has been established to buy the aircraft would, in fact, be substantially controlled by and act on behalf of the federal government, and its transactions should be reflected in the federal budget.

Even if, however, one views the arrangement as a lease, CBO's analysis indicates that the proposal does not meet the conditions for an operating lease described in the *Congressional Scorekeeping Guidelines* and in OMB Circular A-11 and thus does not comply with the terms of section 8159 of the Department of Defense Appropriations Act, 2002.

Honorable Don Nickles

Finally, CBO concludes that implementing the Air Force's proposed arrangement would be more expensive than the service has estimated. While the Air Force estimates that a lease would cost $150 million more than an outright purchase, CBO's analysis indicates that the proposed arrangement would cost $1.3 billion to $2 billion more in present-value terms, or 10 percent to 15 percent more than an outright purchase.

The enclosed report provides CBO's analysis. If you wish further details, CBO will be happy to provide them. The staff contact is David Newman.

Sincerely,

Douglas Holtz-Eakin
Director

Enclosure

cc: Honorable Kent Conrad
Ranking Member

Honorable John W. Warner
Chairman
Committee on Armed Services

Honorable Carl Levin
Ranking Member

Honorable Duncan Hunter
Chairman
House Committee on Armed Services

Honorable Ike Skelton
Ranking Member

Honorable Ted Stevens
Chairman
Senate Committee on Appropriations

Honorable Don Nickles

Honorable Daniel K. Inouye
Ranking Member
Subcommittee on Defense
Senate Committee on Appropriations

Honorable Jerry Lewis
Chairman
Subcommittee on Defense
House Committee on Appropriations

Honorable John P. Murtha
Ranking Member

Honorable Jim Nussle
Chairman
House Committee on the Budget

Honorable John M. Spratt Jr.
Ranking Member

Honorable John McCain
Chairman
Senate Committee on Commerce,
Science, and Transportation

Honorable Ernest F. Hollings
Ranking Member

Assessment of the Air Force's Plan to Acquire 100 Boeing Tanker Aircraft

Congressional Budget Office

August 2003

Contents

Summary

The Department of Defense Appropriations Act, 2002, (Public Law 107-117) authorized the Air Force to pursue a pilot program for leasing as many as 100 Boeing 767 aircraft for up to 10 years and directed the service to describe its plan to the Congress before entering into such a lease. The Air Force, Boeing, the Office of the Secretary of Defense, and the Office of Management and Budget (OMB) reached an agreement in May 2003 for the service to acquire 100 Boeing KC-767A aerial refueling aircraft through a complex financing arrangement. The Air Force submitted the required report to the Congress on July 11, 2003. In that report, the Air Force concludes that the proposed leasing arrangement meets all requirements of the Department of Defense Appropriations Act, 2002, which specified that the terms had to be consistent with the criteria for an operating lease as defined in OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*. The report further concludes that, while leasing would cost about $150 million more (expressed in net-present-value terms) than an outright purchase, leasing is the preferred approach because of the "advantage it affords for quickly delivering needed tankers to our warfighters without requiring significant up-front funding."

After analyzing the Air Force's report and receiving additional information about the proposed lease from the Air Force and Boeing, the Congressional Budget Office (CBO) has concluded that the transaction would essentially be a purchase of the tankers by the federal government but at a cost greater than would be incurred under the normal appropriation and procurement process. The special-purpose entity that has been established to buy the aircraft would, in fact, be substantially controlled by and act on behalf of the federal government, and its transactions should be reflected in the federal budget.

Even if one were to view the arrangement as a lease, CBO's analysis indicates that the proposal does not meet the conditions for an operating lease described in the *Congressional Scorekeeping Guidelines* and in OMB Circular A-11 and thus does not comply with the terms of section 8159 of the Department of Defense Appropriations Act, 2002.

Finally, CBO concludes that implementing the Air Force's proposed arrangement would be more expensive than the service has estimated. While the Air Force estimates that its proposal would cost $150 million more than an outright purchase, CBO's analysis indicates that the proposal would cost $1.3 billion to $2 billion more in present-value terms, or 10 percent to 15 percent more than an outright purchase. On average, the Air Force would spend $161 million per plane in 2002 dollars to lease and then purchase the aircraft, compared to a cost of $131 million per plane for an outright purchase.

The Air Force's Plan to Acquire 100 Boeing Tankers

The Air Force plans to sign a single multiyear contract that will include leasing 100 KC-767A aerial refueling aircraft from a special-purpose entity, called the KC-767A

USAF Tanker Statutory Trust 2003-1 (the Trust). The tankers will be delivered to the Air Force in six groups—four aircraft in 2006, 16 aircraft in 2007, and 20 planes annually over the 2008-2011 period. The Air Force will use each aircraft for six years and pay the Trust an average of $126 million a plane, in 2002 dollars, during that period. At the conclusion of each six-year period, the Air Force can return the aircraft to the Trust or purchase them for a price to be set when the contract is signed. The Air Force currently estimates the purchase price at an average of $35 million per plane in 2002 dollars. Thus, according to its estimate, the Air Force will pay an average of $161 million per plane to lease and then purchase the tankers.[1] The Air Force has not negotiated to purchase the planes directly, but on the basis of the leasing arrangement, CBO estimates that given multiyear procurement authority, the service could negotiate a contract for 100 tankers at an average price of $131 million per plane in 2002 dollars.

The Air Force will be able to terminate the deal prior to the completion of the contract by notifying the Trust one year in advance. However, CBO believes that termination would be costly because the Air Force would have to make an additional payment equal to an annual lease payment on each aircraft and would have to reimburse the Trust for any additional costs that resulted from the decision to terminate.

Financing Arrangements for the Proposal

Boeing and the Air Force have established the special-purpose entity to execute the leasing arrangement and to finance the acquisition of the aircraft. Under the financing plan established by the Air Force and Boeing, the Trust will buy 100 KC-767A tankers from Boeing at an estimated average price of $131 million per aircraft (in 2002 dollars) and will borrow money to make progress payments to Boeing during the construction period for each group of aircraft.

As Boeing completes construction of each group of tanker aircraft, the Trust will issue bonds in the commercial bond market. Boeing and the Air Force estimate that the proceeds from the bonds will need to equal $138.4 million per aircraft (in 2002 dollars), enough to pay Boeing for the remainder that it is owed for the aircraft, repay the principal on the construction loans, and pay interest on the construction loans, which the Air Force estimates at an average of $7.4 million per aircraft.

Press reports indicate that there will be three classes of bonds. The Trust, which will technically own the aircraft, will use the Air Force's annual lease payments to pay principal and interest on two of the three classes of bonds. If the aircraft are sold at

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1. Payments under the Air Force's proposal are based on a negotiated purchase price of $131 million in 2002 dollars. Payments are adjusted for inflation using a combination of the Employment Cost Index and the Industrial Commodities Index.

the end of the lease term, the proceeds will be used to pay off principal and interest on the last class of bonds. The price the Air Force may pay to acquire title to the tankers will be established for all 100 planes at the time the contract is awarded. That amount will be equal to the principal and interest owed on the third class of bonds. Under the terms of the agreement, if the Air Force should choose to forgo purchasing the aircraft and the aircraft are then sold to another purchaser for more than the amount owed on the bonds, any profits from the sale will be returned to the U.S. Treasury.

According to the Air Force and Boeing, the credit rating on the bonds will be based on the strength of the cash flow from the Air Force, rather than on Boeing's credit rating. For that reason, the Air Force expects that the Trust will be able to issue bonds at interest rates that are only slightly greater than Treasury rates. Interest rates on the bonds must compensate investors for the risk that the Air Force might terminate the contract early or might decline to purchase the aircraft at the end of the lease. CBO believes that the small risk premium estimated by the Air Force on borrowing by the special-purpose entity indicates that the Air Force assumes the market will perceive the debt as being backed by the federal government. (See Figure 1 for a graphic display of the management and financing arrangements.)

The Results of CBO's Analysis

CBO reviewed the information contained in the Air Force report, sections of the proposed contract, and the economic analysis prepared to support the Air Force's decision to lease. CBO found that the financing plan envisioned for acquiring the tankers constitutes federal borrowing and spending under standard government accounting principles.[2] CBO also concludes that the proposal does not meet the conditions for an operating lease described in OMB Circular A-11 and thus does not comply with the terms of section 8159 of the Department of Defense Appropriations Act, 2002. While the Air Force acknowledges that acquiring the aircraft with this financing method is more expensive than purchasing them outright, its estimate of the extra cost—at $150 million—is much less than CBO's analysis indicates. CBO concludes that the Air Force would pay approximately $1.3 billion to $2 billion (expressed in net-present-value terms) more to lease and then purchase the tankers than it would to purchase them outright.

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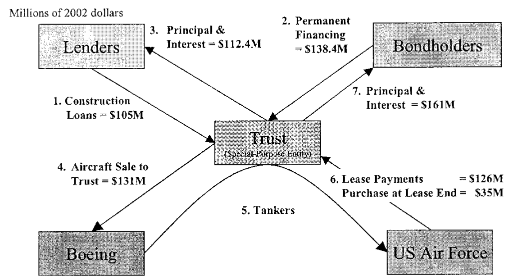
2. The 1967 *Report of the President's Commission on Budget Concepts* suggests a broad definition of federal budget activities, with a few narrow exclusions. It observes that "providing for national security ... obviously constitutes activities of the federal government which should clearly be in the budget." Consistent with other recommendations by the Commission, CBO believes that when the government owns a significant part of an entity's assets or exercises substantial control over the entity's operations, that entity should be included in the federal budget.

Figure 1

Costs Per Aircraft Under the Tanker Financing Plan



1. As Boeing builds the tankers, the Trust will borrow money from commercial banks to make progress payments to Boeing. CBO estimates that, on average, the Trust will borrow approximately $105 million per plane for progress payments.

2. Shortly before the planes are delivered, the Trust will issue bonds to raise $138.4 million per plane in permanent financing.

3. The Trust will use the bond proceeds to pay principal and interest on the construction financing loans, which CBO estimates will average $112.4 million per plane.

4. The Trust will use the rest of the bond proceeds to pay Boeing the remainder it is owed on the aircraft. Total payments to Boeing will equal $131 million per plane.

5. Boeing will transfer title to the planes to the Trust and deliver the aircraft to the Air Force.

6. The Air Force will make lease payments totaling $126 million per plane and a final payment of $35 million should it choose to purchase the planes at the end of the lease.

7. The Trust will use the Air Force's lease and purchase payments to remit $161 million in principal and interest to the bondholders.

SOURCE: Congressional Budget Office.

The Tanker Financing Plan Constitutes Federal Borrowing and Spending

In its report to the Congress, the Air Force indicates that the Administration will record the tanker contract as an operating lease in the federal budget once the contract is signed. Consequently, obligations and outlays will be recorded on a year-by-year basis, reflecting the lease payments due each year to the Trust. CBO believes that recording the transaction as such would be at odds with standard government accounting principles because the proposed financing constitutes federal borrowing and spending. Therefore, the borrowing, resulting aircraft purchases, and interest payments by the special-purpose entity established specifically for this purpose should be recorded in the budget at the time the Trust makes those transactions.

The proposed contract between Boeing and the Air Force, as well as the financing arrangement, clearly indicates that the KC-767A USAF Tanker Statutory Trust 2003-1 exists solely to borrow money on behalf of the federal government to allow the Air Force to acquire an asset that has been built to its unique specifications. The borrowing activities of the special-purpose entity will be directed by a financing committee composed of the Air Force, Boeing, and the lease administrator. (The Air Force has asked Boeing to serve as the lease administrator.) Under the operating guidelines for the financing committee, the Air Force must approve all of the terms and conditions for the financing plan and must review and approve all financing documents.[3] CBO concludes that the actions of that committee will be explicitly controlled by the Air Force.

Because the government will both direct and benefit from the Trust's financing activities (see Figure 2), the Trust will be acting on behalf of the government. Therefore, its borrowing and spending should be treated as federal borrowing and spending and recorded appropriately in the budget. The parties to the lease portion of the contract are the Air Force and the Trust. Since the Trust is an instrument of the government, the government will effectively be buying the aircraft (via the Trust) and then leasing them to itself. To accurately reflect the nature of that arrangement, the federal budget should report the transactions between the Trust and Boeing, and between the Trust and its bondholders, not the essentially intragovernmental transfers between the Trust and the Air Force. Thus, when the Trust pays Boeing for the aircraft, those payments should be reflected as federal outlays. Subsequent interest payments on the Trust's borrowing should also be reflected as outlays when those payments are made. (Federal borrowing is not counted as a government receipt, and the repayment of principal is not counted as an outlay.)

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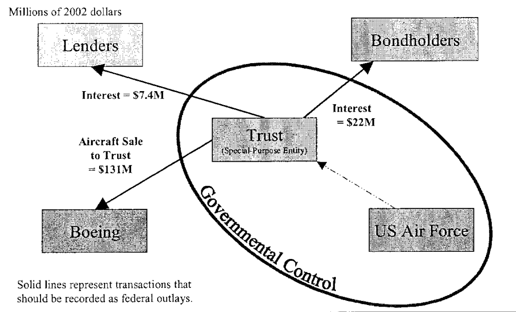
3. Boeing provided CBO with a summary of the operating guidelines for the financing committee. It is available upon request.

Figure 2

Federal Outlays Per Aircraft Under the Tanker Financing Plan



SOURCE: Congressional Budget Office.

Table 1 displays how that budget authority and the associated outlays should be recorded in the budget compared with how CBO believes the department might reflect the contract in the budget.[4] The table also shows CBO's estimate of the cost to purchase the tankers directly using traditional procurement methods. For budget purposes, all amounts are shown in current dollars.

The two budgetary treatments of the financing plan differ substantially. If the proposed transaction is recorded as a purchase, budget authority over the first five years would total $17.3 billion, and outlays would sum to $10.1 billion. If the transaction is recorded as an operating lease, only $1.5 billion in budget authority would be shown over the first five years, and outlays during that period would also total only $1.5 billion, because most of the aircraft would not be available for leasing until 2009.

4. The Universal Service Fund is another example of a federal program administered by a private agency for the federal government. The Universal Service Access Company (USAC), an independent organization that is regulated by the Federal Communications Commission, collects "contributions" from telecommunications service providers and makes payments to other service providers to ensure universal access to telecommunications services. Even though the collections and disbursements are not handled by the Treasury, USAC's transactions are included in the federal budget. In 2002, the agent recorded revenue collections of $5.5 billion and expenditures of $5.1 billion in the federal budget.

TABLE 1. COMPARISON OF POSSIBLE BUDGETARY TREATMENTS OF THE KC-767A TANKER ACQUISITION

	By Fiscal Year, in Billions of Dollars														
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total
TREATMENT OF THE TANKER FINANCING PLAN AS A LEASE-PURCHASE[a]															
Estimated Budget Authority	3.2	3.3	3.4	3.6	3.7	0.2	0.3	0.4	0.6	0.7	0.7	0.6	0.5	0.3	21.5
Estimated Outlays	0.2	1.0	2.3	3.2	3.5	3.7	2.9	1.3	0.6	0.7	0.7	0.6	0.5	0.3	21.5
TREATMENT OF THE TANKER FINANCING PLAN AS AN OPERATING LEASE															
Estimated Budget Authority	0	0	0.1	0.5	1.0	1.6	2.1	2.7	2.9	3.0	2.7	2.2	1.6	1.1	21.5
Estimated Outlays	0	0	0.1	0.5	1.0	1.6	2.1	2.7	2.9	3.0	2.7	2.2	1.6	1.1	21.5
DIRECT PURCHASE OF TANKERS[b]															
Estimated Budget Authority	1.4	2.5	3.0	3.0	3.0	3.0	0	0	0	0	0	0	0	0	15.9
Estimated Outlays	0.5	1.3	2.1	2.8	3.0	2.9	2.2	0.9	0.1	0.1	0	0	0	0	15.9

SOURCE: Congressional Budget Office.

NOTES: In the treatment of the financing plan as a lease-purchase, budget authority reflects the obligation by the Trust to purchase aircraft from Boeing and the obligation to make interest payments to creditors. Outlays reflect payments to Boeing during the time that it takes to construct and deliver the aircraft, as well as interest payments to creditors. In the treatment as a lease, budget authority and outlays equal annual lease payments. In the estimate of a direct purchase, budget authority and outlays reflect estimated costs of a straightforward purchase using the normal appropriation and procurement methods.

The figures do not include funding for operations and support or for military construction projects to house and maintain the new tankers.

a. If the Trust is not considered an instrument of the federal government, the acquisition should be treated as a lease-purchase. Consistent with *Congressional Scorekeeping Guidelines* and OMB Circular A-11, the budgetary treatment would be similar to that of a purchase.

b. The difference in total cost between a direct purchase and either treatment of the financing plan is almost $5.7 billion in current dollars.

In total, by CBO's estimates, acquiring the tankers through a lease would cost \$21.5 billion over the next 14 years. In contrast, CBO estimates, a direct purchase of 100 tankers would cost \$15.9 billion over the same period—but with all of the outlays recorded by the end of 2011.

Budget authority and outlays for the Air Force's proposed lease have two components: the purchase price of the aircraft and the interest costs from the financing arrangement. (Those costs include the additional expense of borrowing money at rates that exceed Treasury's normal borrowing rates.) If the Air Force's proposal is recorded in the budget as a purchase, the purchase price of the aircraft would appear in the first few years when the planes were being constructed, and interest would be recorded annually as the lease payments were made. Of the \$21.5 billion shown in Table 1, \$17.1 billion is for the purchase price of the aircraft, while budget authority for the imputed interest would total \$4 billion over the 2006-2017 period. The remaining \$0.4 billion would pay for insurance and other lease costs. Outlays for the purchase price, which would occur over the 2004-2011 period, would reflect progress payments during the construction period and final payments when the planes were delivered. Outlays for imputed interest charges would coincide with lease payments and would equal the annual budget authority for those charges.

Alternatively, if one chooses not to view the special-purpose entity as an instrument of the government, CBO concludes the arrangement should be reflected in the budget as a lease-purchase, not an operating lease as suggested by the Air Force and Boeing. In that case, the budgetary treatment would be similar to that of the financing plan treated as a purchase (shown in Table 1).[5]

The Proposal Does Not Meet the Criteria for an Operating Lease

After reviewing the details of the proposal, CBO concludes that it does not meet the conditions for an operating lease described in OMB Circular A-11 and thus does not comply with the terms of section 8159 of the Department of Defense Appropriations Act, 2002.

To comply with section 8159 and to be treated as an operating lease in the budget, the lease must meet the following six criteria:

- The asset must be a general-purpose asset, not built to unique government specifications.

- There must be a private-sector market for the asset.

5. For a more in-depth discussion, see Congressional Budget Office, *The Budgetary Treatment of Leases and Public/Private Ventures* (February 2003).

- The present value of the lease payments cannot exceed 90 percent of the asset's fair market value at the start of the lease.

- The lease cannot contain a bargain-price purchase option.

- Ownership of the asset must remain with the lessor.

- The lease term cannot exceed 75 percent of the asset's useful life.

CBO has concluded that the arrangement between Boeing and the Air Force fails to meet the first four of these criteria and complies with the letter but not the spirit of the fifth.

The Lease Must Be For a General-Purpose Asset. Operating leases must be for a general-purpose asset, not one that is built to the unique specifications of the government. An aerial refueling tanker is not a general-purpose asset. Although the tanker is based on Boeing's commercial 767-200 model, the Air Force has specified several significant modifications such as auxiliary fuel tanks, a refueling boom, a refueling receptacle, more powerful generators, and heavier wiring to accommodate unique military requirements. The tanker's aerial refueling capability serves a uniquely governmental purpose.

There Must Be a Private-Sector Market. A private-sector market must exist for any asset obtained through an operating lease. The Air Force and Boeing assert that the lease meets this criterion because Boeing has offered the tanker, called the Global Tanking and Transport Aircraft (GTTA), for public sale. However, the only customers for the GTTA so far are the U.S. Air Force, the government of Japan, and the government of Italy, all of which plan to use the aircraft to refuel their military aircraft. Boeing states that there are a number of private companies that might purchase GTTA aircraft—Omega Air and the Tanker and Transport Service Company Ltd., in particular. CBO does not believe that those companies would buy more than a few of the tankers.

Boeing also points out that some long-haul commercial air carriers may be interested in acquiring the capability for aerial refueling, but none currently employs the technique. CBO believes it unlikely that aerial refueling would make economic sense for commercial transportation companies because they already have access to ground-based refueling services at airfields worldwide. Finally, while Boeing cites many potential customers for the freighter capability inherent in the tanker, how many of the 100 tankers reconfigured as freighters the private market would be able to absorb is unclear.

There are only about two dozen outstanding orders for all Boeing 767 variants. The KC-767A is derived from the Boeing 767-200C variant, for which Boeing has no commercial orders. In fact, according to Boeing, the last delivery of any commercial version of 767-200 aircraft occurred in 2002, and Boeing has no future orders because it now produces 767 models that are superior to the 767-200. Thus, while there may be a private-sector market for a few of the aircraft that the government is acquiring, there is no evidence of such a market for 100 tanker aircraft.

Lease Payments May Not Exceed 90 Percent of the Fair Market Value. To qualify as an operating lease, the net present value of the lease payments may not exceed 90 percent of the fair market value of the aircraft. The Air Force report indicates that the lease payments under the proposed financing arrangement will account for 89.9 percent of the fair market value of the aircraft, which the Air Force calculates at $138.4 million (in 2002 dollars) when the cost of the construction loan financing ($7.4 million per aircraft) is included. CBO believes that including the cost of that financing as part of the aircraft's fair market value is inappropriate because that cost is additional to any interest that would be capitalized in the price of the aircraft in the purchase option. When the financing cost is excluded from the calculation, the net present value of the lease payments accounts for 93 percent of the fair market value.

CBO also notes that, even using the Air Force's methodology, there is a significant possibility that the threshold of 90 percent of the fair market value could be exceeded for at least some of the groups of leased tankers. The lease payments are based on the Air Force's estimate of bond interest rates. If the rates for Treasury bonds are higher than the predicted value used by the Air Force, or if the spread on the interest rates for the bonds issued by the Trust is greater than predicted, lease payments will increase accordingly. Since the Air Force already estimates that the present value of the lease payments will be 89.9 percent of the fair market value, it has no margin for error on its estimate of interest rates.

The Lease Cannot Contain a Bargain-Price Purchase Option. The lease cannot contain an option to purchase the aircraft at a bargain price. The agreement gives the Air Force the option to purchase the aircraft at any time during or at the end of the lease. The Air Force estimates that it could purchase the aircraft at the end of the lease for an average $35 million apiece (in 2002 dollars), or 28 percent of the cost to purchase new tankers. Since the aircraft should last at least 30 years, the aircraft should have 80 percent or more of their life expectancy remaining after six years. While it is difficult to establish the fair market value of used tanker aircraft, CBO believes that paying 28 percent of the cost of a new tanker for a used aircraft with 80 percent of its life left constitutes a bargain purchase price.

Ownership Must Remain With the Lessor. Under the operating lease, ownership must remain with the lessor, and title may not transfer to the government at or shortly after the end of the lease term. CBO believes the Trust is an instrument of the government, given the level of control the government exercises over its operations. Thus, the Trust is effectively purchasing the tankers for the government.

However, if one chooses not to view the Trust as an instrument of the government, the financing arrangement technically complies with this criterion since the purchase option is contingent upon subsequent authorization and appropriation by the Congress. It seems clear for several reasons, however, that the Air Force fully intends to acquire the tankers during or at the end of the lease term.

First, the Air Force and Boeing plan to negotiate a purchase price for each group of planes when the contract is awarded. The Air Force has the right of first refusal on the disposal of the aircraft at the end of the six-year term. The Air Force has also stated its intention to earmark funds to purchase the aircraft.

Second, senior Department of Defense officials have stated on several occasions that the department has a long-term requirement for tankers and that the department plans to replace the entire fleet of KC-135 aircraft over the next 30 years. It seems implausible that the Air Force would return the 100 leased tankers to the Trust since the Air Force plans to retire 68 KC-135E tanker aircraft over the 2004-2006 period regardless of whether the lease is approved and will retire all 131 KC-135E aircraft by 2008 if the lease is approved. Moreover, it would have to accept a significant reduction in its aerial refueling capability if it chose not to purchase (or continue to lease) the KC-767 tankers at the end of the six-year term.

Finally, the Air Force's basing plan for the tankers includes more than $600 million in construction projects to support the permanent basing of the aircraft. Spending those funds would be uneconomical if the Air Force was seriously considering returning the aircraft at the end of the lease term.

The Proposed Financing Approach Is More Costly Than an Outright Purchase

The proposed financing arrangement to acquire the tanker aircraft is significantly more expensive than an outright purchase by the government because of the anticipated interest rates (which are higher than U.S. Treasury rates) and other costs that are unique to the leasing option. By CBO's estimates, total costs for a direct purchase, including the estimated costs for self-insurance, would be about $16 billion (see Table 2). The Air Force reports that it will pay $17 billion to lease the aircraft for six years and more than $4 billion to purchase them at the end of the lease term. Those payments include the interest expense on borrowing by the special-purpose entity. The Air Force will also pay about $400 million for insurance and other expenses related to the lease transactions. Thus, the Air Force estimates that the costs of acquiring the aircraft under the financing arrangement will total almost $22 billion in current dollars. On a present-value basis, the leasing approach would cost $1.3 billion more than an outright purchase, CBO estimates. (The Administration uses a discounting methodology specified in OMB Circular A-94, *Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs,* which, CBO estimates, would result in a greater cost difference of $2 billion relative to a purchase.)

TABLE 2. COMPARISON OF COSTS BETWEEN A DIRECT PURCHASE AND THE AIR FORCE'S PROPOSAL (Billions of Dollars)

DIRECT PURCHASE		AIR FORCE'S PROPOSAL	
Procurement Costs	14.9	Lease Payments	16.6
Nonrecurring Engineering Costs	0.6	Purchase at End of Lease	4.4
Insurance[a]	0.4	Insurance	0.4
		Other Lease Costs	*
Total	15.9	Total	21.5
Present Value	**13.6**	**Present Value**	**14.9**

SOURCE: Congressional Budget Office.

NOTE: * = Less than $500 million.

a. If the Air Force were to purchase tankers directly, it would "self-insure." The value of insurance is shown here to make the total cost of the "direct purchase" option comparable to the Air Force's proposal.

The Air Force's Economic Analysis Understates the Cost Difference

In its report to the Congress, the Air Force indicates that leasing 100 air-refueling aircraft will cost $150 million more than an outright purchase in net-present-value terms (see Table 3). CBO's analysis indicates that the estimate significantly understates the additional cost associated with the Air Force's plan. The Air Force, in fact, does not rule out that possibility, stating that "had the Congress chosen instead to provide multiyear procurement authority and had the Department of Defense been able to accommodate that execution while preserving program stability, the [net present value] could favor purchase by up to $1.9 billion."[6] The Air Force's report notes that this type of analysis is "highly sensitive to the underlying assumptions" but that "in no case approved by OMB did the financial analysis indicate that the net present value of the lease option as being less than that of a traditional purchase."

6. The Air Force appears to attribute the large difference to the effects of multiyear procurement alone. In fact, CBO's analysis indicates that the assumption of multiyear procurement accounts for only $970 million of the $1.9 billion difference.

TABLE 3. MAJOR DIFFERENCES BETWEEN CBO'S ESTIMATE AND THE AIR FORCE'S ESTIMATE OF THE ADDED COST FOR LEASING VERSUS PURCHASING KC-767A TANKERS (In millions of dollars)

	Additional Cost of Leasing (Net Present Value)
Air Force's Estimate	150
Impact of Changing Assumptions:	
Multiyear Procurement Savings in Purchase Price	+970
Proper Inflation of Progress Payments	+640
Compression of Progress Payments	+210
Discount Rate and Interactions Among the Above Factors	-650
CBO's Estimate	1,320

SOURCE: Congressional Budget Office.

Multiyear Procurement. For the lease, the Air Force and Boeing negotiated a price for the aircraft as delivered to the Trust on the basis of the assumption that the Air Force would ultimately lease and acquire 100 airplanes. That assumption allows Boeing to make investments in facilities and equipment that will reduce the total costs of production. It also allows Boeing to purchase parts and components in large quantities to get price breaks from suppliers. For its analysis of the purchase option, however, the Air Force assumed that each lot of aircraft would be bought on an annual basis (that is, with no assurances of subsequent purchases). Thus, no price breaks or production efficiencies were included in the estimated purchase prices.

For the purchase option, the Air Force increased the price of each aircraft by 7.4 percent relative to the price that it used for the lease. CBO believes that estimating the purchase cost under the assumption that a multiyear contract would be granted is warranted because, under section 8159, the Congress has already granted authority for the lease and would likely grant such authority for an acquisition program of that size. The Air Force's statement that it did not assume a multiyear procurement in its analysis of a purchase because it did not currently have that authority is inconsistent with its budgetary practices for other major acquisition programs. The department does not currently have multiyear procurement authority for either the F-22 fighter or the Joint Strike Fighter programs but assumes multiyear procurement in estimating the future purchase costs of those aircraft.

CBO estimates that the cost to acquire 100 KC-767A tankers under the proposed financing arrangement would exceed the cost of purchasing the aircraft under a multiyear contract by $1.1 billion (expressed in net-present-value terms), an increase of $970 million relative to the Air Force's results. Although the Congress has already granted multiyear authority for the lease, in traditional procurement programs, that authority is frequently provided after several years of production prove that the program is stable. If the Congress waited until the third lot to grant the authority, then, by CBO's estimates, the lease would cost $920 million more than the purchase, an increase of $765 million relative to the Air Force's estimate.

Inflation of Progress Payments. The Air Force's method for applying inflation to progress payments is another factor that affects the purchase price in its analysis. During the construction period, a contractor is continually paying for materials and labor. If the government paid the contractor for the full price of the asset at the time of delivery, the contractor would have to borrow money to cover those expenses and include the full costs of that borrowing in the purchase price. Progress payments reimburse the contractor for the costs the company incurs during the construction period and reduce the requirement for the contractor to borrow the money to cover expenses—resulting in a lower purchase price for the government. The government usually limits progress payments to a percentage of the actual costs incurred at the time the request for payment is made.

In its analysis of the cost of a straightforward purchase, the Air Force estimated progress payments as a percentage of the tanker's price, which it inflated to the year of delivery. CBO believes that that method overstates both the amount of the progress payments and the total cost of the aircraft since inflation would affect the cost of material and labor only up to the time those costs were paid. The method also conflicts with the DoD Comptroller's guidance on inflation, which calls for inflating costs to the year the order is made, using an inflation index that takes into account the fact that outlays will occur incrementally between the date the order is placed and the date the asset is delivered. CBO estimates that if the cost of progress payments were inflated only to the time those costs were paid, then the cost of the leasing arrangement would exceed the cost of a straightforward purchase by an additional $640 million (in net-present-value terms).

Schedule for Progress Payments. The schedule for making those progress payments is also a factor that affects the purchase price in the Air Force's analysis. For the option of purchasing the aircraft, the Air Force assumed that progress payments would begin approximately four years before the aircraft were delivered. The assumed payment schedule seems protracted for several reasons. First, the schedule is longer than that of other major aircraft procurement programs. For example, the budget for the C-17 transport program provides advance procurement funding just two years before the delivery date. Other procurement programs, like that for the F-22 fighter, assume that the majority of the progress payments are made over three years.

Second, the Air Force's aircraft procurement programs spend, on average, about 90 percent of budget authority within three years after appropriation. In contrast, the progress-payment schedule that the Air Force used in calculating the costs of purchasing tankers would expend only 75 percent of budget authority in three years, with the last 25 percent of the payments in the fourth year. That progress-payment schedule does not appear to reflect the Air Force and Boeing's plan to deliver the first KC-767A tanker approximately 34 months after lease approval and to deliver subsequent aircraft on an even faster schedule.

Using a four-year progress payment schedule increases the cost of the purchase option in net-present-value terms because it brings forward a large portion of the payments into a period in which the discount factors have less impact. The method appears to conflict with the Department of Defense's Financial Management Regulation, which limits progress payments to a percentage of incurred costs, because it would make payments before work commences. Using a three-year schedule for progress payments (one more in line with historical outlay rates for procuring aircraft) would defer some payments for one year relative to the schedule used in the Air Force analysis and would reduce the cost of the purchase by about $210 million in net-present-value terms.

Discount Rates and Interaction Among The Factors. The results of any economic analysis are sensitive to changes in the discount rate selected. Changes in the discount rate also affect the costs associated with assumptions made about multiyear procurement and progress payments. CBO has calculated the present value of cash flows associated with the planned acquisition of tanker aircraft by discounting the estimated cash flow for each year using the interest rate on a marketable zero-coupon Treasury security with the same maturity from the date of disbursement as that cash flow. That method—often referred to as the "basket of zeros" discounting approach—is used by both CBO and OMB for calculating estimates of loan subsidies under the Federal Credit Reform Act. Although the tanker acquisition plan does not explicitly involve a direct loan or federal loan guarantee, the financing of tankers would result in a series of annual cash flows that have to be matched by the Trust's borrowing (on behalf of the government). Using the basket of zeros to discount that stream of cash flows most accurately reflects the time value of money. Under CBO's approach, the acquisition plan would cost about $1.3 billion more—in present-value terms—than an outright purchase would.

In contrast, the Air Force's analysis relied on the simplified discounting method provided in OMB Circular A-94, which advises using a single discount rate (as opposed to the "basket of zeros"). In implementing the guidelines, the Air Force used a nine-year Treasury rate, based on a three-year construction period and a six-year lease term, to discount the lease payments. CBO estimates that this assumption would result in an additional cost to leasing of $1.7 billion.

However, CBO believes that if a single discount rate is used, the relevant period of analysis should be six years, since the Trust will issue bonds that mature in no more than six years. CBO estimates that using the Administration's method with a single six-year discount rate would yield an even larger present-value difference—a greater cost of about $2 billion for the Air Force's plan.

Other Considerations

Termination Liability

Under the terms of the agreement, the Air Force can terminate the lease prior to the completion of the lease term for its convenience. However, exercising that option would be expensive for the Air Force because of the requirement to pay penalty payments, unamortized costs of the development of the tankers, and additional costs that would arise from its decision to terminate. If it terminates the lease, the Air Force might take delivery of the tankers under construction, make one year's lease payment, and within a year, return them to the Trust along with the penalty payment. Alternatively, it might choose to pay Boeing for the costs of work performed before the decision to terminate. CBO estimates that termination liability could be as high as $5 billion to $7 billion in some years. The Air Force does not intend to set aside budget authority to cover this contingency by using the authority in section 8117 of the Department of Defense Appropriations Act, 2003, and therefore would need an appropriation from the Congress to do so. Given the potential size of the liability and the fact that the Air Force does not intend to budget for it, CBO believes it is extremely unlikely that the Air Force will terminate the lease.

The Long-Term Affordability of Leasing and Then Purchasing Tankers

The Air Force states that its primary reason for choosing this financing arrangement is the favorable budgetary treatment that it will receive. This treatment would allow the service to get the tankers today without displacing other programs from its budget. However, the budget will eventually have to reflect the Air Force's decision to acquire the tankers. When those obligations are eventually recorded, mostly over the 2008-2017 period, they will create additional budgetary pressure in those years.

The Air Force report acknowledges that the lease is a more costly method to acquire the tankers, but the Air Force believes that its decision to pursue the method is justified by lower up-front costs. Total costs to the government are higher under the lease (almost $5.7 billion in current dollars, according to CBO's estimate), however, so rather than eliminating difficult budgetary decisions, the lease merely postpones them.

There is no reason to believe that the Air Force itself will have more budgetary flexibility 10 years from now than it has today. In 2012, for example, the Air Force will be making lease payments on the tankers that were delivered over the 2007-2011 period—about $2.9 billion (in current dollars) a year in payments. It will also have to begin purchasing the leased tankers at an estimated cost of $4.4 billion over the 2012-2017 period. Finally, the Air Force will have to decide how to replace the rest of its KC-135 fleet. Should the Air Force choose to buy more than 100 KC-767s, it would need to start purchasing those additional tankers in 2011 to keep the Boeing 767-200 production line in operation. Procuring 20 tankers annually would cost about $3 billion each year in current dollars, CBO estimates. Designing and building a new tanker would probably cost more and taker longer.

But the Air Force will not just be buying tankers with its aircraft procurement funds over this period. Other Air Force programs will require significant sums also. According to the Administration's published plans and cost estimates, by 2012 the Air Force will be buying 110 Joint Strike Fighters annually at a cost of almost $7 billion per year. Together, those two programs would consume about 70 percent of estimated funding for procuring aircraft. Thus, CBO concludes that the Air Force will likely be faced with making difficult budgetary decisions over the longer term also.

Mr. HOLTZ-EAKIN. That's correct.

Chairman NICKLES. So 10 to 15 percent more or $1.3 to $2 billion in present value more if we did the lease versus the outright purchase.

Mr. HOLTZ-EAKIN. Yes. If you asked the hypothetical question, how much would I have to put aside in an account right now to buy 100 of these planes either through the appropriations process or through this leasing arrangement, it would be $1.3 to $2 billion more expensive. You would need that much more right now to do it via the lease route.

Chairman NICKLES. Now, you mentioned, over the term of the purchasing arrangement, it was a difference of about $5 billion, did you not?

Mr. HOLTZ-EAKIN. That is adding up year-by-year differences and not taking into account the time value of money as the present value would.

Chairman NICKLES. So, nominally, if you looked at the number of dollars, as that would spread out over, what, a 20-year period?

Mr. HOLTZ-EAKIN. Roughly, yes.

Chairman NICKLES. That the total difference would be about $5 billion more?

Mr. HOLTZ-EAKIN. Yes, $5.7 billion is our estimate.

Chairman NICKLES. I appreciate that.

Senator ALLARD. Would the chairman yield on that time value——

Chairman NICKLES. Sure.

Senator ALLARD. In that agreement, there is no set value on interest. So that is a floating figure out there. We do not know what they are going to pay on interest on that, do we? We do not know what the maintenance costs either on that, do we?

Mr. HOLTZ-EAKIN. Indeed, we know, at this point, until the lease is signed, some of the terms are not settled. This is our best estimate, given our understanding of the arrangement. The particular interest costs would be——

Senator ALLARD. That is not fixed in contract, in this agreement at all. I mean, that will change.

Mr. HOLTZ-EAKIN. The lease payments would be fixed in an expectation of covering the expected borrowing costs. So there is imbedded in this arrangement, an expectation of borrowing costs that could then differ.

Chairman NICKLES. Senator Allard, thank you very much, and thank you, Mr. Director.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, and thank you for your presentation, Mr. Director.

First, a few observations when we look at where we are going. I would share Senator Corzine's reaction in looking at these numbers of tremendous, tremendous concern about where we are going; and if we factor in decisions that will be made by this Congress, we are looking at huge, huge budget deficits. I know it is your job to report that, not to create it, but it is a great, great concern. It seems to me we have two basic questions we are debating: one is how to create jobs, and one is how to balance the budget, and do deficits matter?

I think it is self-evident, Mr. Chairman, that we have lost 3 million private-sector jobs in the last 2–1/2 years. That is not debatable. Those are real numbers which say to me that we should be looking at a different way to create jobs. In my State, the unemployment number is going up, not down, which is of deep concern to me.

In terms of balancing the budget, I was there in 1997 when we balanced the budget. I was a proud member of the House to vote for that, the first time in 30 years bringing deficits down, which I think helped certainly the private sector. But now we are looking at these huge deficits again, and we debate, Do they matter? There are a lot of ways to spin it, but just to share with the colleagues and putting this in perspective, am I correct that the projected interest on the public debt for 2003, this year, is $322 billion, my understanding? $322 billion a year, that is 1 year, which is almost as much as the 10-year costs of a Medicare prescription drug plan. So in 1 year, we are talking about interest that is almost as much as that. It is almost 10 times what we spent on homeland security, and I am very concerned, representing the largest border crossing in Northern America, in Detroit, that there has been proposals to actually cut back 30 border inspectors right now when we have deep concern about what is happening there. So we are talking about 1 year's interest payments costing more than 10 times our homeland security costs, and it is almost as big as the entire nondefense discretionary budget. Wouldn't you agree? I mean, we are looking at about $391 billion for most of homeland security, education, health care, environmental protection, basically everything nondefense, nondefense discretionary. So you are looking at 1-year interest payment that almost is as much as the entire nondefense discretionary budget. We could wipe that out, basically, and not touch this deficit.

So this is a big number. This is a huge number. I am deeply concerned about where we are right now and the amount of money that we are putting out in interest compared to other critical needs that people have, just balancing the budget for the future, for the 2008 number that you are talking about.

I would say one other comment, and that is, when Senator Conrad spoke about the $200 billion owed in unpaid taxes by people who are not following the law, not playing by the rules like the majority of Americans, that is basically half of the entire discretionary budget, nondefense discretionary budget, if people were just following the law.

So, Mr. Chairman, I would hope that we would look for those numbers and find, in fact, what is happening with people who are avoiding paying their taxes and following the law.

That is more of a statement. I am going to switch to—because I realize you are reporting the numbers. You are not determining the numbers. But I know people in the State of Michigan are deeply concerned about the money going out in interest that could be going out to fund their child's education or health care or more homeland security at the border or police and fire folks to answer 911.

Mr. HOLTZ-EAKIN. If I could clarify one thing.

Senator STABENOW. Yes.

Mr. HOLTZ-EAKIN. The number for net interest payment by the Government to debt held by the public would be $157 billion. The $322 billion is a gross interest cost, which includes intergovernmental transfers among holdings within various funds.

Senator STABENOW. So it is Social Security, it is—basically, what we are looking at, no matter how you spin the numbers, is a huge amount of money going out in interest at a time when we are struggling to meet homeland security needs and to meet other critical needs. If we also put that in the context that—Senator Conrad has another chart that shows that 96 percent of the spending that we are talking about right now in the last 2–1/2 years has been defense, homeland security, or rebuilding the sites that were attacked on 9/11, 96 percent. So no matter how you look at those numbers, this is a question of limiting our ability to respond to job creation efforts or to meet other needs.

I would like, though, to ask one question on a different topic and get your response to that. There has been a growing concern about the currency intervention of foreign countries, such as Japan and China, and this is of particular concern to leading manufacturing States, such as mine, in Michigan. These aggressive economic distortions are hurting our economy; they are hurting working families.

Recently, I joined with several colleagues in writing to the administration about this issue. If our manufacturing sector and our economy as a whole are to thrive, we need currency markets that reflect the true value of currencies. This manipulation is giving Chinese and Japanese workers unfair advantages over American workers. I am disappointed that Treasury Secretary Snow has been thus far, while in China, unable to convince China to allow its currency to float freely.

But my question to you is: Could you comment on how foreign currency manipulation stymies economic growth here in America and what impact on our own economy there might be if Japan and China stopped what I believe is clearly an unfair trade practice?

Mr. HOLTZ-EAKIN. Well, the question raises a number of very hard economic issues. From the point of view of the economic growth, both in our projection and more generally, one of the key features of the outlook at the moment is that the United States is one of the few countries that has any substantial prospects for rapid economic growth. To the extent that there is more rapid economic growth abroad, in Japan, China, or elsewhere, that would have the most direct impact on our ability to both grow faster and to export more, probably outweighing the particulars of currency values, certainly in the near term.

With respect to the impacts of distorting relative prices, no economist would favor providing misleading price signals through currency intervention or otherwise. It is best if companies faced the appropriate incentives to produce products and consumers faced the appropriate incentives to purchase them. The issue is the degree to which empirically it has been a successful strategy on a sustained basis, actually, in currency markets, and there is a great dispute about that among economists.

Finally, with respect to China, magnitudes matter, and at this point, while the flow of Chinese goods has increased in recent years, it still represents—manufacturing imports from China represent about 2 percent of U.S. manufacturers' shipments. So the degree that we would quantitatively see dramatic differences in manufacturing or broader economic growth from that particular quarter is open to question.

Senator STABENOW. Well, they are growing about 8 percent a year, and so when you look at what is happening with China——

Mr. HOLTZ-EAKIN. They have certainly grown rapidly in recent years.

Senator STABENOW. Yes, absolutely.

Thank you.

Chairman NICKLES. Senator Stabenow, thank you very much.

Next, Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. I am sure glad Senator Stabenow voted for our balanced budget bill. For 40 years we tried to get that out of the House of Representatives. As a member of the Budget Committee, and as John Kasich has tried to do for, I guess, the 8 years he was Chairman of the Budget Committee, we finally got a bill before President Clinton, and he finally signed it into law, and we balanced the Federal budget for the first time in over 40 years. The House of Representatives didn't seem to have much interest in it.

Senator Conrad's charts brought to mind some interesting things, especially the last chart that he put up on the projections of 2001 and showed the red line going straight down. There was no mention on that chart of the two wars that we have been involved in since that time or the New York-D.C. 9/11 attacks. They did have a dramatic, dramatic effect on the budget and the budget deficits and the spending of this Federal Government over the last two years.

I am sure, Senator Conrad, that you will be someone who will be glad to take credit, and I will be, too, if we finally pass a prescription drug benefit for our senior citizens, something we have promised them for the last 10 years. In fact, this Budget Committee put $400 billion in a prescription drug benefit for seniors. My prayer is that it won't explode after the 10 years and will not cost more than the $400 billion that we have allocated. I am hoping that the conference committee will bring back a very substantial bill that will do what we want it to do in the right manner of doing it.

Let me ask some questions of our Director of the CBO. Could you comment on the GDP growth assumed in the CBO projections? It seems to me that you have assumed 2.2percent real GDP growth through 2003 and assume a 3.8percent real GDP growth in 2004 and assume an overall average of 3.3percent from 2005 to 2008, and a 2.7percent from 2009 to 2013. Is that on the laws that are now on the books?

Mr. HOLTZ-EAKIN. Yes.

Senator BUNNING. They are?

Mr. HOLTZ-EAKIN. Yes.

Senator BUNNING. I wonder how you came up with that number.

Mr. HOLTZ-EAKIN. The near-term projection reflects the expectation that, in fact, the economy will grow faster. It reflects the expectation that we will see a recovery in investment, which has been the predominant feature of the economic downturn in recent years. That investment recovery will be stronger in 2004 than in 2003, aided in part by the partial expensing provisions that are current law.

Senator BUNNING. Did that also take in consideration the recession that we picked up in 2000 and carried into 2001?

Mr. HOLTZ-EAKIN. These are built on the current state of the economy reflecting that recession.

Senator BUNNING. OK. Go ahead.

Mr. HOLTZ-EAKIN. We see a cyclical recovery returning the economy back to its potential GDP over the next several years. That particular forecast, the short-term economic forecast, should be distinguished from the long-term projection, which does not attempt to forecast business cycles, but instead focuses on growth in the potential for the economy to produce. That particular potential reflects capital accumulation, the availability of labor supply (both in numbers of people and hours worked), skills, and productivity growth from technological advance.

Senator BUNNING. Did you consult with the Fed?

Mr. HOLTZ-EAKIN. We have a panel of economic advisers, which includes members of the academic community, business forecasters, and our panel meeting was attended as well, in particular, by Vincent Reinhart, who is Director of Monetary Affairs at the Fed. We have been working in conjunction with all experts that we can bring into the process.

Senator BUNNING. So, in other words, you are in consultation with the Fed on the monetary policy of this country. Are you also consulting the Congress of the United States on the fiscal policy?

Mr. HOLTZ-EAKIN. I would hesitate to say that we are in consultation with the Fed on monetary policy. We have a representative come attend our forecast meetings and give us whatever advice he may have to offer. In that way, it reflects whatever critique the Fed may have provided.

Senator BUNNING. Would you think that would be a pretty difficult job in assuming the overall average of 3.3percent from 2005 to 2008 and 2.7percent from 2009 to 2011? That would be a guesstimate rather than an actual forecast?

Mr. HOLTZ-EAKIN. It is our best estimate given what we know about the underlying trends. It is subject to tremendous amounts of uncertainty that we——

Senator BUNNING. If we had another 9/11, would that affect that, do you think?

Mr. HOLTZ-EAKIN. Certainly.

Senator BUNNING. You are also suggesting that we are going to have low inflation and rapid productivity growth.

Mr. HOLTZ-EAKIN. Yes.

Senator BUNNING. Is there any special reason for that?

Mr. HOLTZ-EAKIN. Well, the two, in fact, play into one another, given the underlying trends in productivity, our analyses of the source of advances in productivity growth in the high-technology sectors, and its diffusion through the economy. If you have rapid productivity growth, the capacity for the economy expands more rapidly, and that lessens inflationary pressures, other things equal.

Senator BUNNING. There was someone who was talking—I think it was Senator Corzine—about the Government competing with private sector for money if interest rates happen to go up. I can remember a time in this country—and I know that Senator Corzine can—when the prime rate in this country was over 20 percent. I wonder if we have any more pressure at 1 percent than we do at 20.

Mr. HOLTZ-EAKIN. Well, I think the correct barometer of credit market pressure is real interest rates, adjusted for inflation. Over the long term, one would expect all interest rates to rise to overcome the effects of inflation, so a 1 percentage point increase in sustained inflation is to move up all interest rates. So what we are trying to do is adjust for that——

Senator BUNNING. But we also have a short-term projection, and what I read, the Fed—and that is very difficult to do—it looks like they are saying you are pretty well set for the rest of this year and for the first 4 months of next year at a prime rate of about 1 percent. Then all bets are off, and particularly if there is any kind of inflation that comes into this market.

My projection, or my looking at the market in the monetary policy and in the security and bond market, particularly the corporate bond market, where Chairman Greenspan seems to peg the interest rates, I see a slight inclination to go up. So I would suspect that by next March or April or May, we will see the Fed start to move the prime in direct relationship to the corporate bond rate, which is what he pegs it to—many other things, but, I mean, he also looks at the corporate bond rate very seriously.

Is that an accurate picture?

Mr. HOLTZ-EAKIN. Well, what the Fed will do, we will see. In our projection, what we assume is that interest rates will rise over the course of the next year and a half. Indeed——

Senator BUNNING. That is a pretty——

Mr. HOLTZ-EAKIN [continuing]. Consistent with the Federal funds futures, which show Federal funds rates rising in early 2004. Our projection shows a rise as well.

Senator BUNNING. OK. I have taken my time, Mr. Chairman. Thank you.

Mr. HOLTZ-EAKIN. Mr. Senator, if I could take the liberty of——

Senator BUNNING. Yes.

Mr. HOLTZ-EAKIN. You said at the outset of your remarks that you had budgeted $400 billion and that you would expect $400 billion as well for Medicare prescription drugs in the second 10 years. I want to——

Senator BUNNING. No, I didn't say the second 10 years. I said for the first 10 years.

Mr. HOLTZ-EAKIN. OK. Well——

Senator BUNNING. That is what is in the budget. I am hoping that it will be restrained in the second 10 years.

Chairman NICKLES. I heard you. I think you were talking to me instead of the Director.

Senator BUNNING. That is because you are on the conference.

Chairman NICKLES. Senator Sarbanes.

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

Mr. Director, welcome. We are pleased to have you here. I know this is your first appearance before this committee, I believe.

Mr. HOLTZ-EAKIN. Yes.

Senator SARBANES. It has really been quite a mild, calm hearing thus far, and I hope to keep it on that track.

I must say that the figures you are giving us are really daunting, to put it mildly. You are now projecting, as I understand it, a deficit for 2003 of $401 billion. Is that right?

Mr. HOLTZ-EAKIN. That is correct.

Senator SARBANES. That is as of September 30th, in other words, just a few weeks away. That is what you project the deficit will come in at.

Mr. HOLTZ-EAKIN. Yes.

Senator SARBANES. Now, that is the total deficit. That includes the surplus we are running in Social Security. Is that correct?
Mr. HOLTZ-EAKIN. It is the unified budget deficit, yes.
Senator SARBANES. Unified budget deficit. What is the on-budget deficit?
Mr. HOLTZ-EAKIN. For 2003, our projection is that it would be $562 billion.
Senator SARBANES. $562 billion. Now, you are projecting for next year a deficit, as I understand it, of $480 billion?
Mr. HOLTZ-EAKIN. Yes.
Senator SARBANES. That is the total deficit. What is your projection for the on-budget deficit, in other words, without the Social Security revenue?
Mr. HOLTZ-EAKIN. $644 billion.
Senator SARBANES. $644 billion.
Mr. HOLTZ-EAKIN. Yes.
Senator SARBANES. What were you projecting in March of this year that the deficit would be in 2004, in other words, at the end of next year, the total deficit?
Mr. HOLTZ-EAKIN. Our baseline projection in March was $200 billion.
Senator SARBANES. $200 billion, and you are now projecting $480 billion. Is that correct? Almost two and a half times as much.
Mr. HOLTZ-EAKIN. Yes.
Senator SARBANES. These are very large number, are they not, for deficits?
Mr. HOLTZ-EAKIN. They are large in dollar terms. They are not the largest relative to the economy.
Senator SARBANES. I want to address that in a minute, but in dollar terms, nominal terms, they are by a substantial margin the biggest we have ever had. Is that correct?
Mr. HOLTZ-EAKIN. The previous largest was $290 billion.
Senator SARBANES. $290 billion?
Mr. HOLTZ-EAKIN. Yes.
Senator SARBANES. That is the unified budget?
Mr. HOLTZ-EAKIN. Yes.
Senator SARBANES. Next year you are projecting $480 billion.
Mr. HOLTZ-EAKIN. Yes.
Senator SARBANES. Now, as I understand it, when you make your projections, you work with certain assumptions that are called a baseline approach, which encompasses certain assumptions. Is that correct?
Mr. HOLTZ-EAKIN. Yes.
Senator SARBANES. Now, I want to try to develop this because I think it is very important to try to lay all of this out. The baseline assumes that the existing statutory arrangements will continue. Is that correct?
Mr. HOLTZ-EAKIN. Yes.
Senator SARBANES. So it would not encompass the prescription drug benefit?
Mr. HOLTZ-EAKIN. No.
Senator SARBANES. Which has not yet been enacted, which we are working on. Is that correct?
Mr. HOLTZ-EAKIN. That is right.

Senator SARBANES. It would not encompass the—many people are saying there is going to be a necessity for AMT reform because more and more people are becoming affected by it, and at some point there will be pressure to change that. So there is no allowance for what reform might be done with AMT. Is that correct?

Mr. HOLTZ-EAKIN. That is correct.

Senator SARBANES. Then you are assuming, I guess, in your baseline that these tax cuts which were enacted will expire toward the end of the 10-year period. Is that correct?

Mr. HOLTZ-EAKIN. Yes.

Senator SARBANES. In fact, I noted that the sort of budget benefits that hold down the size of this deficit depend very heavily on an influx of revenue in the end years, of course, resting, as you do with your analysis, on the assumption that those tax cuts—that the taxes will come back into effect, that the tax cut will not become permanent. Is that correct?

Mr. HOLTZ-EAKIN. That is correct.

Senator SARBANES. But I do note that, of course, the President and many in the Congress are pushing very assiduously now to make those tax cuts permanent. Is that correct—well, I won't ask you that. I will just make that as an observation. We are anxious to preserve your nonpartisan status. I think it is very important both for the Director and the Congressional Budget Office.

Now, if those three things were all to change, the surpluses you are projecting right at the tail end of this 10-year period would not be there, would they?

Mr. HOLTZ-EAKIN. That is right.

Senator SARBANES. So, in effect, we would be looking at—while the projections at the moment are that right at the end we would move the budget back into—at the end of this 10-year period, having experienced very large deficits in the interim, we would move it back into surplus. If those three things happen, let alone other things that might happen, including whether the assumption that the increase in programs will parallel inflation rather than running ahead of inflation, leaving that one to one side, we wouldn't be showing any surplus projections for your 10-year period. Is that correct?

Mr. HOLTZ-EAKIN. That is right.

Senator SARBANES. Now, you make a point, and you do it in your statement—and I know you are trying hard here to be balanced. You say, "Although such deficits for this year and next year would be smaller than those of the mid-1980's relative to the size of the economy, they would reach record levels in nominal dollar terms." You repeated that here today.

Now, if I factor in these three items that we discussed—extension of expiring taxes, AMT reform, and a prescription drug benefit—I am really getting to a point where the deficits, even relative to the size of the economy, are really getting very close to those that were in the mid-1980's, am I not?

Mr. HOLTZ-EAKIN. I don't know the exact figure, but the chart I showed at the outset included those three items and very rapid discretionary spending growth. If those four were together, they would, in fact, at the end of the projection produce deficits exceeding those in the 1980's.

Senator SARBANES. Yes, would exceed them. If you had the spending projections plus these other three items?

Mr. HOLTZ-EAKIN. That is right.

Senator SARBANES. Or without these other three items?

Mr. HOLTZ-EAKIN. With those other three. All four in conjunction.

Senator SARBANES. So we would then, in effect, be running record deficits, not only in dollar figures, so-called nominal terms, but record deficits as a percentage of the economy relative to the size of the economy. Would that be correct?

Mr. HOLTZ-EAKIN. If you did all four of those, yes.

Senator SARBANES. Yes. Now, I am interested in the spending increases. There is a chart here, I think—if I could see the 92-percent one, because there is a lot of talk about increases in discretionary spending as though somehow the Congress has gone on some sort of spending binge or something. But as I understand it, the increase in defense spending—and this chart indicates that—92 percent of the increase in discretionary budget authority in the current fiscal year is accounted for by an increase in defense, 75 percent, an increase in homeland security, 10 percent, and 7 percent for trying to make up for 9/11, the special money to New York City, the airline relief, and so forth and so on.

Now, does that correspond with the CBO's analysis?

Mr. HOLTZ-EAKIN. We haven't looked at those numbers, and I would be happy to go through them with the Senator. The projection that I have discussed, the 7.7 percent discretionary spending increase per year, is build on a 5-year historical average. It excludes the impact of the 2003 supplemental, so it is discretionary spending growth, in exclusion of that. If one looks at those numbers, the growth rate is very similar for defense and nondefense discretionary spending, and within nondefense discretionary spending there are growth rates comparable to that or greater in a wide number of areas.

Senator SARBANES. Do you differ with this analysis that the percent of change in discretionary budget authority, that 92 percent of it in 2003 is attributable to these items?

Mr. HOLTZ-EAKIN. Without looking at the construction of those numbers, I really can't say. I would be happy to do that.

Senator SARBANES. Well, this is a very intimidating projection, is it not? I mean, you yourself in some of your statements have made the point that the deficits when the economy is—you are projecting now that the economy is going to pick up and it is going to be closer to full capacity—is that right?—over this time period.

Mr. HOLTZ-EAKIN. Yes.

Senator SARBANES. Is it your view that running substantial deficits when the economy is close to or at full capacity is an inadvisable economic policy?

Mr. HOLTZ-EAKIN. To the extent that going forward we run large sustained deficits in the face of full employment, it will, in fact, crowd out capital accumulation and otherwise slow economic growth.

Senator SARBANES. It will slow economic growth. Is that right?

Mr. HOLTZ-EAKIN. Yes.

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

Chairman NICKLES. Senator Sarbanes, thank you very much.

I have a couple questions, and I think Senator Conrad does, too. Let me just touch on a couple of those.

Senator Bunning asked if you gave consultations on fiscal policy, and you are consulting us; at least you are appearing before the committee, and we appreciate that. You have done it very professionally, and I think all of us are appreciative of that.

Let me ask you for a little advice. Last year, we debated at length whether we should have a 5- or a 10-year budget. If you were giving a recommendation to Congress, is it your thought that a 5-year budget would be more realistic than a 10-year budget?

Mr. HOLTZ-EAKIN. I believe it is a matter of the science of budget projection. The uncertainty associated with 10-year budget windows is extremely large, and I could make a good case for going to 5 years.

But I would attach two caveats to that, quite frankly. The first is the degree to which there are sophisticated consumers of 10-year numbers who understand the uncertainties and don't believe them as point estimates; then more information is better than less. The second caveat is that in some cases, for example, in the growth of the entitlement programs (the numbers I mentioned earlier, for Social Security, Medicare, Medicaid), the underlying determinants are sufficiently easy to project (demographics and structures of programs) that the message of going out to even (2030 where spending that would be 14 percent of GDP) is important information as well for Members to have. That will be the real economic cost of those programs. It will be financed one way or another. But that level of spending is important to bring to the budget process.

Chairman NICKLES. I appreciate that. I raise that for a couple reasons. One, we wrestle with budgets, and we also—when you are trying to put together a 10-year budget, you spend a whole lot of time arguing about things that Congress may or may not do in the next 5 years. Most of the things that Senator Sarbanes just mentioned that may have a negative impact, all of which are going to have to be dealt with by Congress. We make a change in the alternative minimum tax. We make a change on extension. We make a change on discretionary spending. We make a change on entitlement spending. All those have to have an act of Congress, which a future Congress is going to have to wrestle with.

Now, we can guess what we might do, but, anyway, I just mention that.

Let me ask you your advice on another subject. The debt limit right now is for public and government debt?

Mr. HOLTZ-EAKIN. Yes.

Chairman NICKLES. Some have proposed that maybe it really should be debt held by the public alone. Do you concur with that?

Mr. HOLTZ-EAKIN. Well, as I noted in several of my remarks, I think that the debt in the hands of the public relative to GDP is a very useful indicator of the future path of fiscal policy. It reflects in a summary statistic cash in and cash out of the Treasury in the numerator and the performance of the economy in the denominator. Those are the issues that this committee faces all the time. So it is a useful piece of information.

To the extent that you want to align budgetary control mechanisms like a debt limit with that indicator, then you will have both the information and the policy matching up.

Chairman NICKLES. I appreciate that.

Let me ask you a question on entitlements. You mentioned that presently on entitlements, Social Security, Medicare, Medicaid, presently that is 8 percent of GDP in 2002, and it is projected to grow to 14 percent by 2030?

Mr. HOLTZ-EAKIN. Yes.

Chairman NICKLES. That is present law? That doesn't include prescription drugs?

Mr. HOLTZ-EAKIN. That is right.

Chairman NICKLES. I can't remember if it was CBO, or maybe it was OMB, priced the 75-year projections of Medicare and Social Security and showed that Social Security had an unfunded liability of $4.9 trillion and Medicare, $15.8 trillion? Does that sound right?

Mr. HOLTZ-EAKIN. Those are ballpark figures. There have been a variety of estimates provided by both the Treasury Secretary as well as OMB.

Chairman NICKLES. The Medicare 15.8 does not include prescription drugs.

Mr. HOLTZ-EAKIN. No, it doesn't.

Chairman NICKLES. Most estimates of the bills that were considered last year and are presently being considered are in the $4, $5, $6 trillion range, at least the two bills that are in conference, I believe. Is that correct?

Mr. HOLTZ-EAKIN. Yes, at CBO we have been trying to build the capacity to do 75-year cost estimates, for lack of a better word, and while that is not yet completely up to use at the moment, we did use that capacity to take a preliminary cut to see if these reports of a $6 trillion number were in the ballpark. Indeed, they appear to be in the ballpark, if not a little low.

Chairman NICKLES. I appreciate that. Also, I asked you for a study of the two bills that are now pending in conference, the House and the Senate. If my memory serves me correctly, the Senate bill, which we purported to have at $400 billion, but because of an amendment or two that were added, I think you estimated it to be as much as $460 billion. Is that correct?

Mr. HOLTZ-EAKIN. That is right.

Chairman NICKLES. So we do have a challenge. I happen to be one—and maybe I am incorrect—that thinks that those estimates are low. Again, it is very important how we design the program, designing copayments and others; if not, utilization will explode and the costs will greatly exceed estimates. I am just concerned about it. I appreciate your providing the committee some information.

We have a vote ongoing, and I know Senator Conrad has additional questions, so I will turn to him. I have an interest in this question as well.

Senator Conrad.

Senator CONRAD. I would like to go back to the lease agreement with the Air Force because I think it is a very important public policy question. The difference here, when the time value of money is taken into account, is $1.3 billion to $2 billion. Is that not correct?

Mr. HOLTZ-EAKIN. That is right.

Senator CONRAD. That is the difference. What the Air Force is saying to us is, look, CBO does not take into account the difference in the capacity that we are buying, so the question of value of what we are getting versus cost. Of course, you can't do that. That is not your charge.

The Wall Street Journal had an editorial today in which they say they are mistaking cost for value in an attack on the tanker leasing deal, and they point out that these planes are more than 43 years old, that then Air Force Secretary James Roche realized the urgency of the problem when he peeled back the skin of a tanker being refurbished and found the metal underneath was disintegrating.

They go on to point out that age isn't the only problem. Not only will the new 767s be able to refuel all planes in the military's inventory, unlike the existing planes, but they carry up to 20 percent more fuel and 3 times the cargo.

They go on to point out that Boeing's main competitor is the European consortium that produces Airbus, which virtually defines corporate welfare.

Their final point is that the real issue is not just lifetime cost but value for money. They conclude that the Air Force needs tankers now, and the leasing arrangement was deemed the way to get tankers into its hands most expeditiously, not least because it bypasses procurement procedures that could stretch out a buying decision for years.

I make these points because I think all of these facts have to be on the table when people make a determination. Cost is obviously an important factor, and there is a differential, $1.3 to $2 billion, when the time value of money is taken into consideration.

There also is a hard reality we have been presented with. The Air Force has told us they need these planes, they need them urgently, and that these planes have more capacity, substantially more than the existing fleet, and that these planes, unlike the existing planes, can refuel all planes in the inventory.

You know, we have a very curious situation right now. The tankers can only refuel Navy planes. Then they have to land. Then they have to retool. Then they can refuel Air Force planes. These new tankers would be able to refuel both Navy planes and Air Force planes without having to land to retool.

So I think all these issues have to be in front of us before we make a decision.

Chairman NICKLES. Senator Conrad, thank you.

Just one final comment on Boeing, and I guess you are going to make a presentation today before the Commerce Committee.

Mr. HOLTZ-EAKIN. Yes.

Chairman NICKLES. From a budgetary standpoint, you have already mentioned that a lease is going to cost $1.2 to $2 billion more, and that is on present-value dollars. Over the life of the contract, it will be as much $5.7 billion, for a difference of at least $31 million if you are trying to say the purchase price today per plane. That seems to me to be—the Air Force, I believe, was saying that they thought it would be a total difference of cost of $150 million.

Do you know what that—not $4.6 billion. They were saying $150 million. What is the difference?

Mr. HOLTZ-EAKIN. The difference comes from a variety of sources. One would be the assumption by the Air Force that if one were to get the same planes at the same schedule through the regular appropriations process, Congress would not provide it with multiyear procurement authority, which indeed Congress could provide, and there is precedent for that taking place.

The second difference is the assumptions about the kinds of interest costs built into the lease arrangement, and there we have tried to detail it out. There are some interaction factors as well. But the bulk of it is the procurement authority and the assumption that using the appropriations process to deliver the same 100 planes on the same schedule would somehow not yield the cost savings associated with multiyear procurement.

Chairman NICKLES. OK. From a budgetary standpoint—and this is one of my big concerns about it—it seems to me just to bypass the budget. This is a way—we are going to go into leasing; therefore, it won't show up until outyears when we are writing the checks and when they are ultimately purchased. So you would have a cash-flow chart that won't have as much money up front, and it will have a big swing at the end when in the last years you will be writing big checks.

Mr. HOLTZ-EAKIN. What I would emphasize in response to Senator Conrad's remarks is that indeed our analysis is independent of value. It is focused on budgetary treatment, which the Chairman just mentioned, and on two alternative routes, the cost of two alternative routes. One route is the leasing arrangement. The second route would be for Congress to provide additional budget authority to the Air Force to purchase the same planes on the same schedule, either at the expense of other military programs or perhaps just by raising total BA. If it did that, the overall costs of the program would be lower.

Chairman NICKLES. What about the budgetary aspect—does it seem to you that this type of a mechanism really just bypasses the budget?

Mr. HOLTZ-EAKIN. Yes.

Chairman NICKLES. To me, I think we need to be very cognizant of that. We could have any of the authorizing committees say, well, we are going to do lease-purchase arrangements and make all kinds of financial commitments that really wouldn't be noted, except for maybe asterisks, there will be some expenses coming down in the future. But there is a liability to the Federal Government that is coming, and I kind of think it should be on budget. So I make mention of that.

We have a vote. The time is almost expired.

Senator SARBANES. Mr. Chairman?

Chairman NICKLES. I will call on Senator Sarbanes to conclude.

Senator SARBANES. I wanted to ask one quick question. What real GDP growth rate do you think we could sustain and be at a full-capacity economy?

Mr. HOLTZ-EAKIN. Our long-term projections, the 3.3 percent from 2005 to 2008, and 2.7 percent thereafter, are our estimates of full-employment growth rates in the outyears.

Senator SARBANES. What is the unemployment rate that goes with those projections?

Mr. HOLTZ-EAKIN. 5.2 percent.

Senator SARBANES. Now, we were at 4 percent for a while and seemed to be able to sustain it without an inflationary economy, 4 percent unemployment and sustain it without an inflationary economy. Why wouldn't we seek a higher growth figure that would bring with it a lower unemployment rate and—well, if we base it off this recent experience, not an inflation problem?

Mr. HOLTZ-EAKIN. In the long run, the inflation problem will reflect more the Federal Reserve's targets in monetary policy. With respect to the real growth rate of the economy, it will be dictated by the rate at which we accumulate capital, labor, and technologies, the key of those being productivity growth. The difference between very rapid productivity growth in some years in the late 1990's and our sustained average productivity growth in the outyears is probably the biggest difference.

Senator SARBANES. Well, now, Greenspan seemed to have the view that we had done something of a breakthrough on productivity growth, and I thought there were figures recently that seemed to sustain that given where we are. Is that not right?

Mr. HOLTZ-EAKIN. I can't speak to the Chairman's views, but our productivity growth, 2.1 percent over the budget window, is, in fact, a rate which is close to but not equal to the peaks of the post-1995 acceleration.

Senator SARBANES. All right. Well, thank you very much, and the hearing is adjourned.

Mr. HOLTZ-EAKIN. Thank you.

[Whereupon, at 12:16 p.m., the committee was adjourned.]

Russ Feingold

Statement of Senator Russ Feingold
Senate Budget Committee
September 3, 2003

Chairman Nickles and Ranking Member Conrad, thank you both for calling this hearing so that the committee may consider the most recent report of the Congressional Budget Office on the economy and the state of the federal budget. One of the most important tasks of this committee is to provide some overview of the federal budget. While every other committee may focus on the spending or revenue aspects of the budget that fall into their particular jurisdiction, this committee is responsible for looking at the big picture.

In fact, the Budget Committee was created as part of the budget reforms of the early 1970s in part because no single committee had been really focusing on the overall budget picture. And the creation of the Budget Committee along with the other budget enforcement mechanisms that were enacted back then, and that were subsequently strengthened, helped us solve the problem of chronic budget deficits, a problem that, prior to the projections we see today, was at its most challenging back in the early 1990s.

Mr. Chairman, I first ran for the United States Senate on the issue of bringing the deficit under control. When I took office in January of 1993, the unified budget deficit was a whopping 290 billion. The on-budget deficit was something like $340 billion. And we were looking at $300 billion deficits for years to come.

But thanks to some very tough decisions by President Clinton and the Congress we were able to climb out of that deficit hole and actually achieve a balanced budget. In fact, we had built what was projected to be a modest budget surplus - enough to start paying down the huge federal debt that had been building up in anticipation of the projected strain on budget resources when the baby boomer generation begins to retire.

Against that background, the report presented to the committee today is particularly discouraging. The speed, and apparent indifference, with which all the work to balance the budget was undone is alarming.

We now face a budget hole that is even greater than the one we faced at the beginning of 1993. According to the report prepared by CBO, we are looking at unified budget deficits totaling $1.4 trillion over the next 10 years. And that figure almost certainly understates the probable deficit totals. A more likely projection would be about $5 trillion when the costs of extending expiring tax cuts, needed Alternative Minimum Tax reform, increased defense spending, and a Medicare prescription drug benefit are added in.

And when you exclude the surpluses from the Social Security Trust Fund the 10-year deficit projections rise to $7.5 trillion.

Mr. Chairman, under any reasonable set of assumptions the government credit card will be getting quite a workout over the next 10 years. We are running up a mountain of debt, and it will bury our children and grandchildren. They are the ones who will have to pay for this. The deficits Congress and the White House create today will be paid for by our children and grandchildren. That is precisely the tradeoff Congress and this administration have made and continue to make. Tax cuts and increased spending for us, and our kids will have to pay the bill.

This is not a sustainable policy. As several members of the nonpartisan Concord Coalition wrote in a column a few months ago:

> Congress cannot simply conclude that deficits don't matter. Over the long term, deficits matter a great deal. They lower future economic growth by reducing the level of national savings that can be devoted to productive investments. They raise interest rates higher than they would be otherwise. They raise interest payments on the national debt. They reduce the fiscal flexibility to deal with unexpected developments. If we forget these economic consequences, we risk creating an insupportable tax burden for the next generation.

The Concord Coalition is right. We have to get off this disastrous fiscal path and absolutely key to doing so, and getting back to a responsible budget, is a meaningful set of budget enforcement rules.

Mr. Chairman, the first rule for getting out of a hole is to stop digging, and for the projected deep budget hole we now face that means, first and foremost, reinstating the PAYGO rule and statute. Congress lived with PAYGO enforcement in one form or another until this past April. It was instrumental in helping to restrain the collective fiscal appetites of both Republicans and Democrats, and we ought to embrace that discipline again. I very much regret that the PAYGO extension I was able to add to the budget resolution in the Senate was dropped in conference. It was a modest reform, and had it been in place the likely budget deficits projected over the next 10 years would not be nearly as bad as they appear to be today.

There are other common sense budget enforcement rules that we ought to explore as well, and I very much hope this committee will take a look at them. I have been pleased to work with Senator Voinovich to introduce some of these ideas, including biennial budgeting, a concept long championed by our distinguished former Chairman, Senator

Domenici.

Mr. Chairman, there is some common ground on this issue in this committee. Our own Ranking Member, Senator Conrad, may be the most outspoken and passionate advocate for fiscal responsibility in the Senate, and as I mentioned, our former Chairman, Senator Domenici, has long fought for budget discipline both in this committee and in the Senate as a whole.

We absolutely have to get back to the budget discipline that served us so well. The fiscally responsible budgets established by Congress and the previous administration were responsible not only for balancing the government's books but also for the truly remarkable period of economic growth we saw during the 1990s.

I very much hope the Budget Committee will take the report prepared by CBO to heart, and make budget enforcement reform its highest priority for the remainder of the 108^{th} Congress.

Jim Bunning 9/3/03

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON THE BUDGET
CBO'S BUDGET AND ECONOMIC OUTLOOK
September 3, 2003

THANK YOU, MR. CHAIRMAN.

I WAS CONCERNED, AS I'M SURE WERE MOST MEMBERS OF THIS COMMITTEE, TO READ THE NEW C.B.O. BUDGET ESTIMATES FOR FISCAL 2003 AND 2004. WHILE THESE NUMBERS ARE BELOW HISTORICAL HIGHS WHEN CALCULATED AS A PERCENTAGE OF THE ECONOMY, THEY ARE OBVIOUSLY HIGHER THAN WE WOULD LIKE TO SEE.

THESE NUMBERS BRINGS INTO STARK REALITY THE MAGNITUDE OF THE JOB BEFORE US IN THIS CONGRESS: WE MUST DO WHAT WE CAN TO HELP GET OUR ECONOMY BACK ON TRACK AND WE MUST HOLD THE LINE ON SPENDING – ALL WHILE PROTECTING THE CITIZENS OF THIS COUNTRY FROM THOSE WHO WISH US HARM.

THIS COMMITTEE AND THIS CONGRESS HAVE MADE A COMMITMENT TO FISCAL RESTRAINT WITH THE PASSAGE OF THE FISCAL YEAR 04 BUDGET RESOLUTION. THAT BUDGET ATTEMPTS TO HOLD THE LINE ON MUCH DISCRETIONARY SPENDING.

UNFORTUNATELY, OUR COUNTRY HAS BEEN FACING MANY CHALLENGES WHICH ARE MAKING BALANCING THE BUDGET VERY DIFFICULT – WE FACE FISCAL COSTS TO MEET DEMANDS IN SECURITY BOTH AT HOME AND ABROAD.

I WISH WE COULD PROTECT OUR PEOPLE WHILE BALANCING THE BUDGET AT THE SAME TIME – UNFORTUNATELY, THAT IS NOT THE POLITICAL REALITY THAT WE FACE.

I THANK THE NEW CBO DIRECTOR AND HIS STAFF FOR THEIR HARD WORK AND DEDICATION AND FOR HIS WILLINGNESS TO APPEAR BEFORE US TODAY TO EXPLAIN THE ANALYSIS OF HIS OFFICE IN DETAIL.

THANK YOU.