S. HRG. 111–107

CONCURRENT RESOLUTION ON THE BUDGET FY 2010

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

January 8, 2009—THE CBO BUDGET AND ECONOMIC OUTLOOK

January 15, 2009—THE DEBT OUTLOOK AND ITS IMPLICATIONS FOR POLICY

January 21, 2009—ADDRESSING SHORT- AND LONG-TERM FISCAL CHALLENGES

January 28, 2009—FEDERAL RESPONSE TO THE HOUSING AND FINANCIAL CRISIS

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February 10, 2009—KEY ISSUES AND BUDGET OPTIONS FOR HEALTH REFORM

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March 10, 2009—THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL

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July 16, 2009—THE LONG-TERM BUDGET OUTLOOK

Printed for the use of the Committee on the Budget

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THE CBO BUDGET AND ECONOMIC OUTLOOK

THURSDAY, JANUARY 8, 2009

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

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

Present: Senators Conrad, Wyden, Feingold, Lautenberg, Cardin, Whitehouse, Gregg, and Sessions.

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

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I would like to welcome everyone to our first Budget Committee hearing of the year. Today we will focus on CBO's new budget and economic outlook. Our witness today is Robert Sunshine—what an apt name for what we confront—the Acting Director of the Congressional Budget Office. Director Sunshine has been leading the CBO since late November when former Director Peter Orszag was nominated to be the head of the Office of Management and Budget in the new Obama administration.

We hope to have Doug Elmendorf formally appointed to the CBO Director spot soon. We have taken the necessary action here. We await our House colleagues' action. We hope to have that concluded, as I say, very quickly.

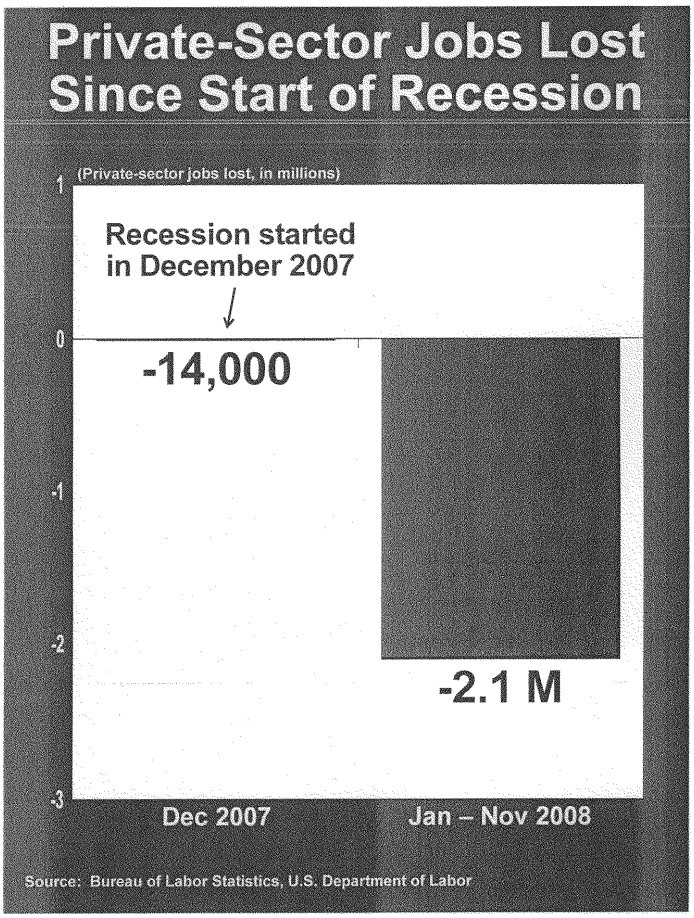
Director Sunshine has been with CBO for about 33 years, almost since the agency was established. His years of work at CBO have been outstanding. We could not ask for more exemplary work than the work of Bob Sunshine. He is a great asset to the Congress and to our Nation, and we deeply appreciate your moving this forecast forward so that we would have available the most recent, relevant information to Congress as it begins its deliberations on the economic recovery package and as we begin the budget process for the year—a budget process that is truly daunting.

Director Sunshine is joined today by Robert Dennis, CBO's Assistant Director for Macroeconomic Analysis. Assistant Director Dennis has been with CBO for almost 30 years, and, again, we want to thank you for, I know, the extraordinary effort that has gone into producing this forecast well ahead of the normal schedule. Thank you for your service to the country as well.

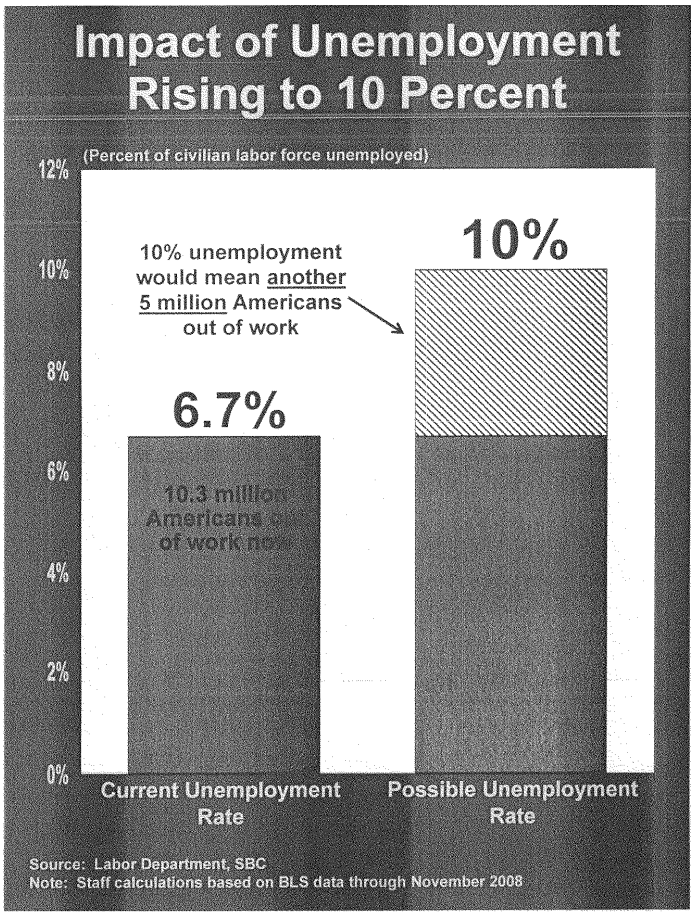
Unfortunately, the news you are bringing, through no fault of your own, is not good. The new deficit projections, as I said yesterday, are jaw-dropping. This is one of the worst budget forecasts I have seen in my life. President Obama is walking into a fiscal dis-

aster of stunning proportion, coupled with an economic downturn of unknown duration and depth, but one that I think we can already forecast will be longer than any other downturn since the Great Depression and not exceeded in severity since the Great Depression.

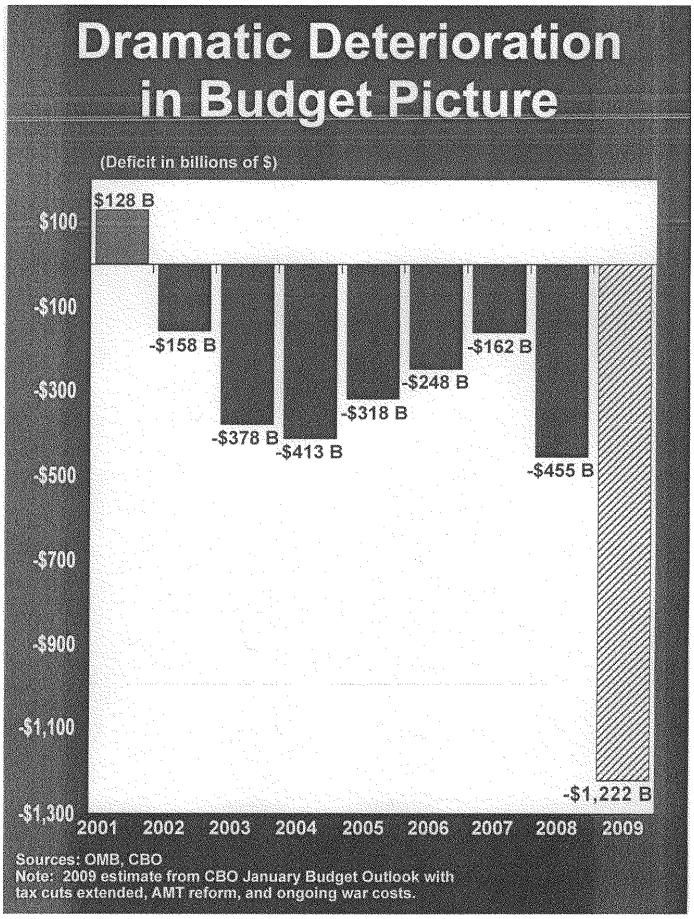
Let me just go through a couple of charts to put in perspective what we confront, if we could. In job loss, we have lost, from January through November of last year, over 2 million jobs. And, economists' estimates for December are of deep concern, an expected job loss approaching 700,000 for 1 month.



Second, some economists are now forecasting that we will reach a level of unemployment of 10 percent. That is up from the 6.7 percent now. If we went to a level of 10 percent unemployment, that would mean an additional 5 million people losing their jobs.

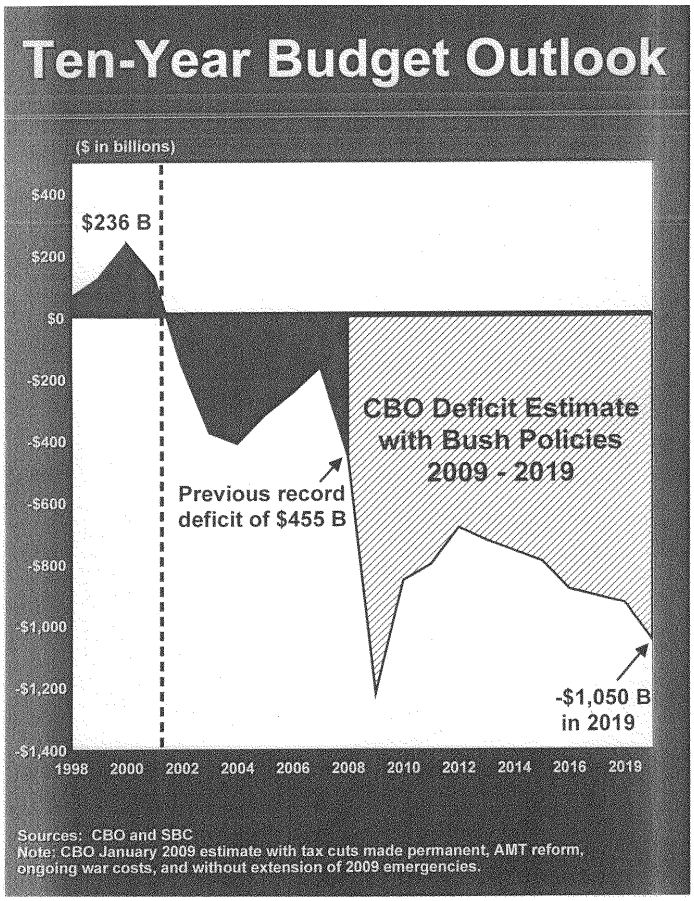


We have also seen a very dramatic deterioration in our budget picture. CBO's new estimates show that the deficit in 2009 will be over $1.2 trillion—$1.2 trillion. That is assuming the extension of certain tax cuts, the alternative minimum tax reform, and ongoing war costs. It does not include any money for the economic recovery plan. This is more than 2–1/2 times last year's record deficit. And, again, that is before we adopt any economic recovery plan.

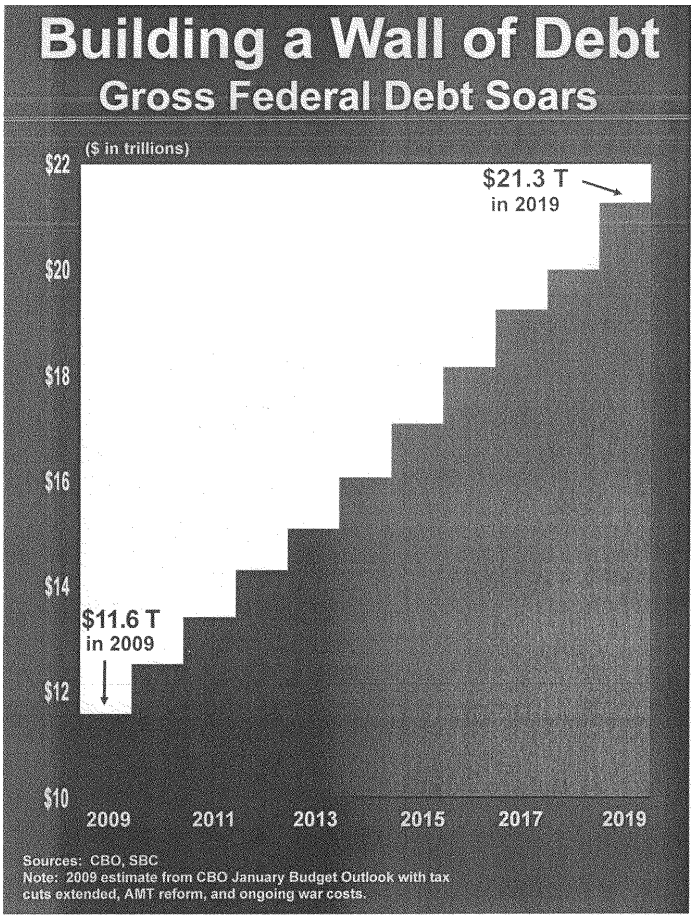


It is important to remember that the increase in debt in 2009, as distinct from the deficit, will be even greater. We believe the increase in the debt before any economic recovery package will be in the range of $1.6 trillion. So we could easily reach an additional debt, once an economic recovery package is put in place, of $2 trillion in 1 year alone. To put that in perspective, our current gross debt of the United States is about $10.6 trillion. And CBO's 10-year outlook confirms that with current policies, such as the tax

cuts extended, alternative minimum tax reform, and ongoing war costs, we will see record deficit for years to come.



Our Nation is building a wall of debt that is certainly sobering and I think should give us all pause. Gross Federal debt is now estimated to reach $11.6 trillion in 2009; and if we add in current policies, such as the tax cuts extended, the alternative minimum tax reform, the ongoing war costs, it could rise to over $21 trillion by 2019. Again, that is without any economic recovery costs included.



Our long-term outlook is even more serious. The combination of the retiring baby-boom generation, rising health care costs, and inadequate revenues will explode deficits to clearly unsustainable levels. CBO's latest long-term budget outlook, which was released in December of 2007, shows that the Federal debt could climb to more than 400 percent of gross domestic product by 2058. We are at about 70 percent gross debt to GDP now.

Without any new policies, just the extension of current policies, we see the debt to GDP approaching 100 percent by 10 years from

now. But if we stay on this course, we see the debt then soaring to 400 percent of GDP by 2058. This is utterly unsustainable. The bipartisan fiscal task force that I have proposed, along with Senator Gregg, could be the basis for a process that I believe will be needed to tackle our long-term fiscal challenges. I am open—and I am certain Senator Gregg, who can speak for himself, is open—to other suggestions, but I believe that what we have proposed is something that is badly needed.

Here are the highlights of the task force proposal: It would be tasked with addressing our long-term fiscal imbalances. It would consist of lawmakers and administration representatives. Everything would be on the table. The panel's legislative proposal would get fast-track consideration, and Congress would have to vote on the proposal. It would be designed to ensure a bipartisan outcome.

I do not pretend that this is the magic bullet that solves all of our problems, but as I look ahead, it is becoming increasingly apparent that we simply cannot allow our fiscal condition to continue to drift downward. That way lies American economic decline. And so I think it is critically important that we face up to these long-term imbalances and look at both the spending side and the revenue side of the equation.

In announcing his economic team in November, President-elect Obama said, "Short term, we have got to focus on boosting the economy and creating jobs. Part and parcel of that is a plan for a sustainable fiscal situation long term." He has that exactly right, and that is precisely what Senator Gregg and I are calling for. Our Nation's economic future will remain at risk until we confront the long-term fiscal challenge before us.

Let me just add, if there is any doubt about the importance of facing up to these long-term imbalances, the news that was spread across the front page of the New York Times today on "China Losing Taste For Debt From U.S." ought to be a warning signal to us all. China has now become our biggest creditor, and this article says very, very clearly that China is losing taste for debt from the United States. If they pull back from taking on U.S. debt, what are the ramifications for our economy? What would be the effect on interest rates? What would be the effect on economic growth?

The New York Times

THURSDAY, JANUARY 8, 2009

China Losing Taste for Debt From the U.S.

Key Lender Finds Uses for Money at Home

By KEITH BRADSHER

HONG KONG — China has bought more than $1 trillion of American debt, but as the global downturn has intensified, Beijing is starting to keep more of its money at home, a move that could have painful effects for American borrowers.

The declining Chinese appetite for United States debt, apparent in a series of hints from Chinese policy makers over the last two weeks, with official statistics due for release in the next few days, comes at an inconvenient time.

On Tuesday, President-elect Barack Obama predicted the possibility of trillion-dollar deficits "for years to come," even after an $800 billion stimulus package. Normally, China would be the most avid taker of the debt required to pay for those deficits, mainly short-term Treasuries, which are government i.o.u.'s.

In the last five years, China has spent as much as one-seventh of its entire economic output buying foreign debt, mostly American. In September, it surpassed Japan as the largest overseas holder of Treasuries.

But now Beijing is seeking to pay for its own $600 billion stimulus — just as tax revenue is falling sharply as the Chinese economy slows. Regulators have ordered banks to lend more money to small and medium-size enterprises, many of which are struggling with lower exports, and to local governments to build new roads and other projects.

"All the key drivers of China's Treasury purchases are disappearing — there's a waning appetite for dollars and a waning appetite for Treasuries, and that complicates the outlook for interest rates," said Ben Simpfendorfer, an economist in the Hong Kong office of the Royal Bank of Scotland.

Fitch Ratings, the credit rating agency, forecasts that China's foreign reserves will increase by $177 billion this year — a large number, but down sharply from an estimated $415 billion last year.

China's voracious demand for

Continued on Page A10

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

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman, and thank you for those sobering words. And I want to join you in thanking the CBO team here. You had to work very hard during the holidays. I know your families were impacted by that, and we very much appreciate that work, and the product that you have brought forward, al-

though stark and obviously a product that causes us all pause, is something that we needed to hear. And we thank you for getting it to us quickly.

Picking up on the Chairman's comments, we are facing something that is totally unique that we have not confronted as a Nation before, at least certainly in the post-World War II period; and our running room, so to say, is limited. Whereas maybe in the earlier times we had more capacity to deal with a situation like this, right now our options are limited.

There are a couple numbers that jump out at me, and I want to sort of second everything the Chairman said, especially relative to the approach that should be taken here regarding a bipartisan initiative to try to get our hands around the out-year costs of entitlements. But a couple numbers that really jumped out from your report are that it looks like we are going to see spending in 2009 at about 24.9 percent of GDP, which would be the highest level since 1945; and it looks like tax revenues will be at about 16.5 percent of GDP, which will be one of the lowest levels since the 1950's. Those two numbers lead inevitably to disaster and cannot be tolerated for an extended period of time.

I do greatly respect much of what has been said by President-elect Obama on how they intend to address this issue relative to the stimulus package. And I just want to highlight my concerns, and I sense, at least, that the representation is that they are also the concerns of Larry Summers and Treasury Secretary Designate Geithner.

The reason the budget deficit is going to balloon so dramatically—can we put up that chart there?

This sort of shows it: $1.186 trillion is CBO's estimate, not counting the stimulus. And if you put the stimulus on top of it, you are headed toward $2 trillion.

The reason that occurs is in large part two changes compared to CBO's baseline issued in September 2008: one is the radical drop in revenues, and two is the expenditures which occur as a result of our attempt to at least soften the impact of this extraordinarily difficult economic time through spending, which is deficit spending, by the Federal Government. I think it is critical that on the second item, which is the spending—we make sure that all that spending that we undertake, whether it is in the stimulus or whether it is by TARP or whether it is in the basic budget process, but especially the stimulus and TARP, be one-time events which, when they are finished, will have added to our capacity as a Nation to compete and be more productive in the global marketplace.

The TARP is actually an investment in assets, that should be returned to the taxpayer as the economy turns around and we get these assets paid back to us, maybe even with interest and make a little money. The stimulus package, on the other hand, is in large part a payment out of the treasury, but it should be one-time payments. It should not be initiatives that expand the base of the Federal spending and increase programmatic activity that goes beyond the stimulus event; and it should be focused primarily on things which are going to return us to a more competitive Nation in the area of infrastructure and in the area of tax policy, which appear to be the two primary thrusts of the emerging stimulus bill, along

with the payments to the States, which I have a whole separate set of issues with.

So I am hopeful that as we hear your thoughts on this, you can give us your ideas as to what type of mechanisms and what type of initiatives we should put in place in order to make sure that when we jump from a $1.186 trillion deficit this year up to $1.8 trillion as a result of the stimulus, that number comes down almost as fast as it goes up in the out-years as we move away from the stimulus package by having it be a one-time event with very strict enforcement of sunset rules and things like that.

This is obviously such a unique situation and the problem is so dire for our Nation that we cannot approach it in a partisan way. There are a lot of ideological issues here. You know, as a conservative, I obviously have an inherent dislike of having the Government expand dramatically and having, obviously, deficits of this size. But I also recognize that in this type of economy, something has to be done, and if the Government is sort of the spender of last resort here, it just has to be done right. And it is my attitude, and I think it is the attitude of our party on our side of the aisle within the Senate, that we want to be cooperative here because we realize the seriousness of the situation, and we are hopeful that we can reach some bipartisan initiatives which will address the short-term problem, which is the slowdown, and at the same time address the long-term problem, which is the looming fiscal crisis of the baby-boom generation.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Gregg.

Mr. Sunshine, we will turn to you, and, again, you have the thanks of this Committee and you have the thanks of the Senate for working through the holidays to develop this forecast well ahead of the normal schedule to help us deal with the decisions that must be made. Again, our thanks.

STATEMENT OF ROBERT A. SUNSHINE, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY ROBERT A. DENNIS, ASSISTANT DIRECTOR FOR MACROECONOMIC ANALYSIS

Mr. SUNSHINE. Thank you, Mr. Chairman, Senator Gregg, members of the Committee. I am delighted to be here today to present CBO's latest budget and economic projections. I suppose I would be more delighted if I had lots of good news to communicate, but as you know, that is not the case. The budget outlook for this year and for at least the next couple of years is not at all encouraging. The first chart here shows exactly what is going on.

As a share of the economy, we expect the deficit this year to be the largest recorded since World War II. Assuming no changes in tax or spending policy, and that is assuming no—taking into account no possible stimulus legislation, we project that the deficit will total $1.2 trillion, or 8.3 percent of GDP. A stimulus would add to that.

Now, the baseline then shows some improvement as the deficit drops to 4.9 percent in 2010 and levels off at around 1 percent of GDP in the out-years. But that is not a prediction of what is going to happen because, as we know, the baseline makes certain as-

sumptions about the continuation of current law. So it assumes that there is no AMT fix. It assumes that we continue spending on military activities like those in Iraq and Afghanistan, only $68 billion a year that we have funded for this year. It assumes that the 2001 and 2003 tax cuts expire, which pumps up revenues in the out-years. So that it is a benchmark, a measure of what we think would happen under current law, not necessarily a prediction that within a few years we will be down to a deficit of 1 percent of GDP. It is very likely, as we all know, that some policies will differ from the ones that I have just described.

The question then is: Well, how did the deficit get to be that big? $1.2 trillion is an enormous number compared to any other deficits that we have seen, and there are a small number of major factors that account for that. One of the most significant ones is on the revenue side of the budget. Because of what has happened to the economy, we have a revenue decline of $166 billion from last year to this year. That is a drop of 6.6 percent. That is a combination of the recession, drops in the stock market, and as a matter of fact, what happens is not only are revenues lower than they were last year, they are lower than they were 2 years ago. And if revenues had, say, gone up by 4 or 5 percent a year over the 2-year period, what you might expect in a more normal kind of environment, they would be $300 or $400 billion higher this year. And that has a very significant impact on the deficit.

The second big piece is the Troubled Asset Relief Program, which was enacted last fall, and we have $180 billion in outlays in the deficit estimate for that program. Now, that is potentially $700 billion of purchases—that is a program that involves potentially $700 billion of purchases, but we do not record those—as specified in the law, we do not record those on a cash basis. We record those on an estimated present-value-loss basis. So our estimate assumes that all $700 billion of that program is carried out, and we estimate a net loss of around a quarter, about 25 percent, ultimately, on those transactions. That $180 billion represents most of that loss, and we have a little bit showing up in 2010. So that is the second big piece. You have a big drop in revenues. You have $180 billion in outlays for TARP.

And then the third really big piece is that we have incorporated in these estimates over $200 billion, roughly $240 billion for Fannie Mae and Freddie Mac. These entities have had a close relationship with the Government for many years. They were created by the Government. They have been called "Government-sponsored enterprises." We are now taking them over, and CBO believes that the link is now so close and so clear that the activities of Fannie and Freddie belong in the Federal budget. It was, in fact, a reasonably close call before now, but now it seems clear to us that that is where they belong. We ultimately do not make that decision. The Office of Management and Budget will make that decision. But we have included them in the numbers here, and we have included about $200 billion for the net loss on the difference between assets and liabilities of those entities when we took them over and another roughly $40 billion for their activities this year.

That is a potentially confusing number because that is not the same number as the amount that the Government will actually

have to put into those entities in cash. They are very different concepts. The cash concept has to do with the way the entities account for their profits and losses and what their balance sheets look like. The $200 billion number is a more credit reform, long-term type calculation. We are not estimating that the Government will have to infuse $200 billion into those entities this year. The estimate is, I believe, $18 billion for this year. So that is sort of a confusing number, but it adds over $200 billion to our deficit. So those are the three biggest pieces, and together they add $700 or $800 billion to the deficit.

Even without Fannie and Freddie, if you took that $240 billion out of the deficit number, you would still have a deficit of $966 billion, and it would still be the largest deficit as a percentage of GDP since World War II. So it makes the deficit look substantially bigger, but the deficit is still very large, regardless of whether you count Fannie and Freddie in the numbers or you do not.

There are other smaller factors—they are only small in comparison to these very large factors—that are adding to the deficit this year. Costs of unemployment compensation are up by $36 billion. Nutrition assistance, food stamps—what we used to call food stamps—is up by $11 billion. Social Security, Medicare, and Medicaid are up by $111 billion, almost 9 percent. There was a very big cost-of-living adjustment in benefits from Social Security this year because earlier last year the inflation rate was quite high. And deposit insurance costs are up by several billion dollars.

On the other hand, the one bit of good news is that Federal interest costs are down because the interest rates on Federal debt are now so low.

Chairman CONRAD. Is that the sunshine in this forecast?

[Laughter.]

Mr. SUNSHINE. Yes. A little bit. A little bit. So those are the major changes.

Now, here is the difference between—this actually is similar to the slide that Senator Gregg put up where we compare the deficit that we estimate now with the deficit that we estimated last September. Again, lower revenues, the TARP spending, and the impact of Fannie and Freddie account for virtually all the change in our deficit since last September.

Now, as the Chairman has pointed out, this is having an enormous impact on the public debt. We estimate in our report that the debt held by the public will reach 50 percent of GDP in 2009. That is the highest since sometime in the 1950's. The debt held by the public was very large as a percent of GDP in World War II, and it gradually declined over the following few decades. But it has not been at 50 percent since sometime in the 1950's, and we have estimated it will hit 54 percent in 2010.

Chairman CONRAD. Can I just stop you on that point? Because people listening to this may be confused. I talked about 70 percent debt to GDP currently. You are talking about 50 percent. We should make clear to those listening that you are talking about debt held by the public. I am talking about gross debt, the total debt that we have. That is the reason for the difference. It is not a disagreement between us. We completely agree when you use the same measure.

Mr. SUNSHINE. Yes, that is correct. For example, the Social Security trust fund balances are invested in treasury securities, and that is counted as part of the gross debt, and the figures I am talking about exclude that kind of debt, intragovernmental debt, debt that we owe ourselves because we have made promises to do certain things in the future. And we have been focusing on the debt when the Government borrows money from the public.

The highest that figure has been in recent years, it was 49 percent in the mid-1990's, so we are not yet at a point where it is dramatically different from our experience in recent decades, but it is—well, more than at the high end, it is above the high end of anything we have seen.

Chairman CONRAD. What is your number for the gross debt percentage to GDP?

Mr. SUNSHINE. About 70 percent.

Chairman CONRAD. That then is the number I am using, 70 percent. So we are in agreement on that. And when I look at your forecast, when I look at an extension of current tax policy, alternative minimum tax reform, as well as war costs, we are approaching 100 percent of GDP on the gross debt in 10 years. And that would take us to a level approaching where we were after World War II. I think after World War II we were 125 or 126 percent of GDP.

Mr. SUNSHINE. Yes, it was over 100 percent.

The next slide I think makes the point that you have been making, and it is similar to the one you showed, Mr. Chairman. This is a projection of debt held by the public from our long-term projections that we did last fall. We have two scenarios because there are all kinds of different assumptions one can make about what it means to continue current policy. One is what is probably viewed as a relatively conservative assumption as to what the current policy means. The alternative fiscal scenario, the higher one, assumes things like an SGR fix, discretionary spending growing at the rate of GDP, an AMT fix, continuation of existing tax cuts. Either one produces a result in terms of debt held by the public out a few decades, the lower one more than 200 percent of GDP, the upper one much higher than that. And as CBO Directors for quite some time have been saying, you know, we are on a path that is an unsustainable path from the Nation's fiscal policy perspective. It is caused to a significant degree by the rising costs of health care and Federal health programs. It is caused also by the aging of the population. And it is a tough problem. Assuming—and I expect we will—we get by the difficult short-term situation that we are in, whether it is in a year or 2 years, this problem will still exist. And, at best, we will not have exacerbated it, and in trying to deal with the short-term problem—well, we may have exacerbated it in trying to deal with the short-term problem, but we are almost certainly not making it much better.

Chairman CONRAD. If I could just interrupt you there, too, and say that is why the words of Senator Gregg are wise admonitions, that while we do short-term things to lift the economy, we have got to guard against doing things that would make our long-term circumstance worse. And that is what I hear you saying today.

Mr. SUNSHINE. That is correct. That is correct.

Having given all that good news about the budget, let me just touch on some of the key economic factors just so we can have a clear picture of what they are.

We estimate that real gross domestic product will decline by 2.2 percent in 2009. That is also the largest single-year decline in real GDP in any year since World War II. And we have relatively slow growth in 2010, only 1.5 percent. The overhang of the financial crisis, the loss of wealth, and the various other factors that have contributed to the recession we think are going to not lead to a sharp uptick in growth that you sometimes see after a recession. So we have 1.5-percent growth in real GDP in 2010.

By our estimate, this recession will last until the latter part of this year, which means that is at least 19 months since it started a year ago December. That will make it the longest of any of the post-war recessions. The longest of those was 16 months. A number of other recessions were much shorter than that.

This will also be in our estimate the deepest recession. By deep, we mean the extent to which the economy is performing under its capacity. And we estimate that over the next 2 years, the economy will average 6.8 percent—GDP will average 6.8 percent below its potential.

We have the unemployment rate peaking early in 2010 at more than 9 percent. The unemployment rate tends to peak after the recession is over and then hedge down. It keeps going up for a little while. It is not that long ago, early in 2007, when we had an unemployment rate of 4.5 percent. It seems like a long time ago. In the past 50 years, the unemployment rate has hit 9 percent only twice: one in 1975 for a month, and then for a period in 1982 and 1983.

The next slide shows the gap that I have been talking about, with the smooth upper line being the potential gross domestic product, if the economy is functioning on all cylinders; and the bottom curly line shows what we estimate will happen, and the gap between them is the lost output as a result of the economic circumstances. It is also an indication of how much ground you have to make up, but also how much room you have to work with in terms of stimulating the economy before you start running into the constraints of an economy that is operating close to potential. Now, ultimately in our baseline we project that the economy will return to close to potential over several years out, but it does not get there until somewhere around 2014 or 2015.

This is a comparison what this recession will look like in our view with what the typical previous recessions have looked like. We are now about a year into the recession. In previous recessions, the average business cycle, the recession is actually over by now. Usually they last two or three quarters and they are over. That would be the average business cycle. Here we are already more than 12 months into the recession, and we have not even hit the worst part yet. So we projected there will be a much longer recession and the recovery will be quite gradual. And so we will get 4 years out where we ordinarily get 2 years out. It will take us 4 years to get to the point of recovery that we ordinarily get 2 years after the recession has begun.

That has some ramifications for the kinds of steps one might think about taking to address it—and, in fact, whether one thinks

you ought to take steps to address it. One caveat, though, I need to remind the folks in the room is that if you compare our economic assumptions with those of other forecasters, they are done on a different basis. Most of the forecasters make assumptions about what the Government is going to do, and they will assume some kind of stimulus package in their forecasts. As always, in doing our baseline we assume no further legislative action. So other forecasts may look more positive than ours in part because they assume that there is some kind of legislative action on the part of the Congress.

I would like to touch briefly on the question of stimulus. This was not addressed in our report yesterday, but I thought it was important that we talk about it.

In the absence of any changes in policies, we estimate that the economy will produce $1 trillion less in output per year than its estimated potential in 2009 and 2010. That is that gap. And it is significantly less than its potential in 2011 and 2012.

Many economists believe that a stimulative fiscal policy is desirable under these kinds of conditions. Recessions are characterized by a self-reinforcing cycle. Firms cut production and they cut employment because of a fall-off in sales, and then people have less income and they have less confidence, and they are more stressed financially; they buy less. Companies have lower sales; they cut more people. And you can get a self-reinforcing cycle.

A fiscal stimulus can dampen that cycle by increasing spending, whether it is by households, by businesses, or by governments. Some degree of fiscal stimulus occurs automatically when the Federal budget goes into a deficit, the big revenue shortfall that we talked about, additional spending on unemployment compensation, food stamps. Those things all help offset the decline in demand in the private sector.

The Government has the option of providing additional stimulus, either on the tax side by reducing taxes or by increasing payments to individuals or by conveying resources to State and local governments, or by doing things itself, by buying goods and services itself.

The Fed is also stimulating the economy. The Fed has been very aggressive and innovative in providing economic stimulus. But there still remains the question as to whether the things the Fed has done will be sufficient to both stabilize the financial system, which it shows signs of doing, and providing a significant boost to demand in the economy. Ultimately we need to do both, and it is not clear that the very aggressive actions by the Fed will actually succeed in doing both.

Another way of thinking about it is even if one thinks that the CBO forecast is not too bad, we can live with it—and it is not a terribly optimistic forecast—things could be worse. I mean, there is no great science to forecasting the economy. Economists have a very difficult time predicting turning points. The outcome could be better than we predict, but it also could be worse. And one can also think about taking legislative action as a kind of insurance policy to ensure that it—or to try to ensure that the situation does not turn out worse and hopefully it turns out a little better.

There are three key criteria that we think need to be applied in thinking about fiscal stimulus. The first is timeliness. It is important that the effects of the stimulus occur when the need for the

stimulus exists, when you have that gap, which means that, since we are already in the recession, one probably ought to do it quickly, and one ought to do things—if you want to have an effect on closing that gap, one ought to do things that take effect quickly. That means if it is getting money into the hands of people or businesses or governments, if it gets into their hands 2 years from now, that is probably not—it is not going to help with the big gap in the economic output.

It does not have to take effect during the technical period that we call a recession, because if we have weak growth following the recession, it may also be helpful to stimulate the economy then. But what you do not want it to do is you do not want it to kick in when the economy is growing rapidly and the output is getting close to potential.

A second key criterion is that it is desirable that the policies be cost-effective, that you get bang for the buck. The most effective policies in that regard put money, resources in the hands of households or firms or governments that will spend them. If people save—saving in the long term is a really good thing for the economy, but saving now is not a good thing for the economy. And if we put the resources into the hands of individuals or firms or governments that do not spend them now, then you do not get bang for the buck in terms of economic stimulus.

There is another tradeoff. The other tradeoff is if you push too hard to spend things quickly, you might not spend them wisely, because sometimes it takes time to think out carefully exactly what one—whether it is infrastructure projects or other kinds of things, to determine exactly what are the most productive ways to spend those things and what kinds of projects are the right ones. And so you have a tradeoff between the desire to spend money quickly and the need to be thoughtful about how we spend it.

There are some potential policies that simply change the timing of spending, and that if we simply accelerate certain types of things, like accelerated depreciation, for example, it would ultimately be a cost to the Government anyway, but move them from a time period when we need the fiscal impact less to a time period when we need the fiscal impact more. That actually has very little net cost to the Government, but it may be helpful in terms of stimulus.

So timeliness, cost-effectiveness, and then something that we have already talked about, you want to avoid doing things that significantly exacerbate the Nation's long-term fiscal problems. Policies that may be very desirable and helpful in the short run may not be beneficial or may even be harmful to addressing the Nation's long-term fiscal challenges.

Fiscal stimulus adds to the Federal debt. For every $100 billion in Federal debt, the future taxpayers will probably wind up paying about $5 billion a year in interest costs. Large deficits, persistent deficits, slow economic growth—they reduce national savings, they reduce capital accumulation, and they reduce over the long term the economy's capacity to produce. Spending, on the other hand, if one finds ways to stimulate the economy in ways that enhance the Nation's productivity over the future, that can offset some of that problem.

Then, as the Chairman has pointed out, a large increase in debt poses risks. At some point investors here and abroad may decide that they have enough treasury securities and they are not interested in having a lot more. It may then start costing us a lot more to finance our Federal debt.

We risk losing some flexibility in future financial crises. Right now we can borrow lots of money, and we are, and it has been very helpful. But at some point, you may reach a point where the debt is sufficiently large that that is not so easy to do or it is very expensive to do.

And, finally, spending or tax changes that are enacted that are intended to be temporary may or may not be easy to reverse later. Programs and policies take on a momentum, a life of their own, and it is certainly possible to enact things where all intention is that they be temporary, but they may not turn out to be temporary.

Chairman CONRAD. We have certainly seen that.

Mr. SUNSHINE. So those are the three main criteria, we think, that the policymakers ought to think about in addressing fiscal stimulus.

Before I conclude, I would just like to thank two groups of people, a brief commercial. One group of people is the Committee staff on both sides of the aisle who have been very helpful and supportive and encouraging to me and to CBO during this transition period, and we appreciate their guidance and their support and their help. And I would certainly be remiss if I did not mention, as you have mentioned, the enormous amount of hard work that the CBO staff has put in over the past couple of months, working over the holidays to produce this report, producing the two very large health reports in December, and as well as a whole lot of other estimates and reports that have been going out. There is a very dedicated group of people that are not in this room that have made all those things possible, as well as some dedicated people who are in this room, and I am—and I hope you are—very grateful to them for doing that.

Chairman CONRAD. We are indeed.

Mr. SUNSHINE. I am happy to answer any questions.

[The prepared statement of Mr. Sunshine follows:]

Congressional Budget Office

Testimony

Statement of
Robert A. Sunshine
Acting Director

The Budget and Economic Outlook: Fiscal Years 2009 to 2019

before the
Committee on the Budget
United States Senate

January 8, 2009

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Thursday, January 8, 2009. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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

Chairman Conrad, Senator Gregg, and Members of the Committee, thank you for inviting me to testify on the Congressional Budget Office's (CBO's) most recent analysis of the outlook for the budget and the economy. My statement describes CBO's new economic forecast and baseline budget projections, which cover fiscal years 2009 through 2019. Those estimates were released yesterday in the report titled *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*.

The sharp downturn in housing markets across the country, which undermined the solvency of major financial institutions and severely disrupted the functioning of financial markets, has led the United States into a recession that will probably be the longest and the deepest since World War II. The Congressional Budget Office anticipates that the recession—which began about a year ago—will last well into 2009.

Under an assumption that current laws and policies regarding federal spending and taxation remain the same, CBO forecasts the following:

- A marked contraction in the U.S. economy in calendar year 2009, with real (inflation-adjusted) gross domestic product (GDP) falling by 2.2 percent.
- A slow recovery in 2010, with real GDP growing by only 1.5 percent.
- An unemployment rate that will exceed 9 percent early in 2010.
- A continued decline in inflation, both because energy prices have been falling and because inflation excluding energy and food prices—the core rate—tends to ease during and immediately after a recession; for 2009, CBO anticipates that inflation, as measured by the consumer price index for all urban consumers (CPI-U), will be only 0.1 percent.
- A drop in the national average price of a home, as measured by the Federal Housing Finance Agency's purchase-only index, of an additional 14 percent between the third quarter of 2008 and the second quarter of 2010; the imbalance between the supply of and demand for housing persists, as reflected in unusually high vacancy rates and a low volume of housing starts.
- A decrease of more than 1 percent in real consumption in 2009, followed by moderate growth in 2010; the rise in unemployment, the loss of wealth, and tight consumer credit will continue to restrain consumption—although lower commodity prices will ease those effects somewhat.
- A financial system that remains strained, although some credit markets have started to improve; it is too early to determine whether the government's actions to date have been sufficient to put the system on a path to recovery.

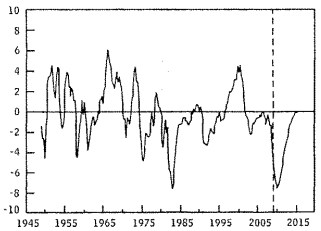
The major slowdown in economic activity and the policy responses to the turmoil in the housing and financial markets have significantly affected the federal budget. As a share of the economy, the deficit for this year is anticipated to be the largest recorded since World War II. Under the rules governing CBO's budget projections—that is, an assumption that federal laws and policies regarding spending and taxation remain unchanged—the agency's baseline reflects these key points:

- CBO projects that the deficit this year will total $1.2 trillion, or 8.3 percent of GDP. Enactment of an economic stimulus package would add to that deficit. In CBO's baseline, the deficit for 2010 falls to 4.9 percent of GDP, still high by historical standards.
- CBO expects federal revenues to decline by $166 billion, or 6.6 percent, from the amount in 2008. The combination of the recession and sharp drops in the value of assets—most significantly in publicly traded stock—is expected to lead to sizable declines in receipts, especially from individual and corporate income taxes.

Figure 1.

The GDP Gap, 1949 to 2019

(Percentage of potential gross domestic product)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: The GDP gap is the difference between real (inflation-adjusted) gross domestic product and its estimated potential level (which corresponds to a high level of resource—labor and capital—use).

Data are quarterly and are plotted through the fourth quarter of 2019.

- According to CBO's estimates, outlays this year will include more than $180 billion to reflect the present value of the net cost of transactions under the Troubled Asset Relief Program (TARP), which was created in the fall of 2008. (Broadly speaking, that cost is the purchase price minus the present value, adjusted for market risk, of any estimated future earnings from holding purchased assets and the proceeds from the eventual sale of them.) The TARP has the authority to enter into agreements to purchase assets totaling up to $700 billion outstanding at any one time, but the net cost over time will be much less than that amount.

- The deficit for 2009 also incorporates CBO's estimate of the cost to the federal government of the recent takeover of Fannie Mae and Freddie Mac. Because those entities were created and chartered by the government, are responsible for implementing certain government policies, and are currently under the direct control of the federal government, CBO has concluded that their operations should be reflected in the federal budget. Recognizing that cost in 2009 adds about $240 billion (in discounted present-value terms) to the deficit this year.

- Economic factors have also boosted spending on programs such as those providing unemployment compensation and nutrition assistance as well as those with cost-of-living adjustments. (Such adjustments for 2009 are large because most of them are based on the growth in the consumer price index over the four quarters ending in the third quarter of 2008.)

The Economic Outlook

CBO anticipates that the current recession, which started in December 2007, will last until the second half of 2009, making it the longest recession since World War II. (The longest such recessions otherwise, the 1973–1974 and 1981–1982 recessions, both lasted 16 months. If the current recession were to continue beyond midyear, it would last at least 19 months.) It could also be the deepest recession during the postwar period: By CBO's estimates, economic output over the next two years will average 6.8 percent below its potential—that is, the level of output that would be produced if the economy's resources were fully employed (see Figure 1). This recession, however, may not result in the highest unemployment rate. That rate, in CBO's forecast, rises to 9.2 percent by early 2010 (up from a low of 4.4 percent at the end of 2006) but is still below the 10.8 percent rate seen near the end of the 1981–1982 recession.

The Near-Term Outlook

In preparing its economic forecast, CBO assumes that current laws and policies governing federal spending and taxes do not change. This forecast, therefore, does not include the effects of a possible fiscal stimulus package. On that basis, CBO anticipates that real GDP will drop by 2.2 percent in calendar year 2009, a steep decline. CBO expects the economy to begin a slow recovery in the second half of 2009 and to grow by a modest 1.5 percent in 2010 (see Table 1).

CBO expects inflation to continue to decline, both because energy prices have been falling and because inflation excluding energy and food prices—the core rate—tends to ease during and immediately after a recession. For 2009, CBO anticipates that the increase in the CPI-U will be only 0.1 percent. For 2010, CBO forecasts the CPI-U to be higher—at 1.7 percent—because energy prices are not expected to lessen inflation that year.

Table 1.

CBO's Economic Projections for Calendar Years 2009 to 2019

	Estimated	Forecast		Projected Annual Average	
	2008	2009	2010	2011-2014	2015-2019
		Year to Year (Percentage change)			
Nominal GDP (Billions of dollars)	14,304	14,241	14,591	18,211 [a]	22,500 [b]
Nominal GDP	3.6	-0.4	2.5	5.7	4.3
Real GDP	1.2	-2.2	1.5	4.0	2.4
GDP Price Index	2.4	1.8	0.9	1.6	1.9
PCE Price Index[c]	3.3	0.6	1.3	1.7	1.9
Core PCE Price Index[d]	2.2	1.5	0.9	1.7	1.9
Consumer Price Index[e]	4.1	0.1	1.7	2.1	2.2
Core Consumer Price Index[f]	2.3	1.6	1.3	2.0	2.2
		Calendar Year Average (Percent)			
Unemployment Rate	5.7	8.3	9.0	6.4	4.8
Three-Month Treasury Bill Rate	1.4	0.2	0.6	3.8	4.7
Ten-Year Treasury Note Rate	3.7	3.0	3.2	4.8	5.4
Tax Bases (Billions of dollars)					
Economic profits	1,533	1,384	1,413	1,952 [a]	2,187 [b]
Wages and salaries	6,548	6,551	6,740	8,344 [a]	10,324 [b]
Tax Bases (Percentage of GDP)					
Economic profits	10.7	9.7	9.7	10.5	10.1
Wages and salaries	45.8	46.0	46.2	45.8	45.9
		Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP	2.3	-0.5	3.9	5.7	4.3
Real GDP	-0.4	-1.5	3.0	4.0	2.3
GDP Price Index	2.6	1.1	0.8	1.7	1.9
PCE Price Index[c]	1.8	1.4	1.1	1.8	1.9
Core PCE Price Index[c]	2.1	1.2	0.9	1.8	1.9
Consumer Price Index[e]	2.5	0.6	1.7	2.1	2.2
Core Consumer Price Index[f]	2.1	1.5	1.3	2.1	2.2

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

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

Economic projections for each year from 2009 to 2019 appear in Appendix B.

a. Level in 2014.

b. Level in 2019.

c. The personal consumption expenditure chained price index.

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

e. The consumer price index for all urban consumers.

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

The sudden decline in economic activity in the second half of last year signaled that the recession could be severe. The recession was precipitated by a drop in house prices and housing starts, which abruptly undermined the solvency of financial institutions and severely disrupted the functioning of financial markets. A sharp rise in oil prices between early 2007 and the middle of 2008 further debilitated economic activity. Those recessionary pressures were largely offset for a time by strong growth of exports and by government policies that included a significant easing of monetary policy and tax rebates during the spring and summer of 2008. By the middle of last year, the growth of output had weakened but remained, on average, about 2 percent. By the fall of last year, however, additional turmoil hit financial markets even though policymakers had provided extraordinary amounts of support to the markets in order to contain it (see Appendix A). As spending by consumers and businesses weakened, output fell at an annual rate of 0.5 percent in the third quarter and probably fell much more in the fourth quarter. The price of oil also dropped rapidly late last year; if sustained, lower oil prices will temper the decline in output.

Normally, sharp contractions in economic activity are followed by rapid rebounds, but this forecast anticipates that the recovery in 2010 will be slow for a number of reasons. Although financial conditions are expected to improve, the pace of improvement will be restrained because it will take time for financial institutions to recover from losses due to loan defaults. As a result, borrowers will continue to find the terms and availability of credit tight, which will increase the cost of capital and hold back the growth of investment and consumption, dampening economic activity for several years. Similarly, the excess supply of vacant houses is expected to suppress the typical rebound in housing construction next year. Spending also will be muted as households continue to adjust to the large declines in wealth of the past few years. Last, foreign economies will not provide an offsetting boost in demand: Although economic growth overseas remained strong during the housing collapse of 2007 and 2008, providing support to U.S. producers, those economies are now weakening and are likely to restrain the U.S. recovery in 2010.

The federal budget will provide some support to the economy in 2009 and 2010, even in the absence of any new stimulus legislation. Federal tax liabilities (and therefore revenues) fall proportionately more than incomes in recessions, and that additional drop dampens the decline in households' real after-tax spending power. In addition, spending on some programs, such as those providing unemployment insurance and the Supplemental Nutrition Assistance Program (formerly known as the Food Stamp program), automatically increases during recessions. Those recession-induced changes in the federal budget tend to smooth out economic cycles. The magnitude of those "automatic stabilizers" can be only roughly estimated, but in CBO's forecast about $250 billion of the change in the deficit (about 1.8 percent of GDP) between 2008 and 2009 appears to be attributable to them.[1]

In contrast, spending by state and local governments will only mildly ease the downturn in economic activity. In response to lower-than-expected revenues and requirements for balanced budgets, they are cutting back their spending on goods and services, and CBO's forecast assumes essentially no real growth in that spending this year. Total state and local deficits (including both the operating and the capital accounts) will increase, but the change in the total deficits will be small relative to the recession-induced change in the federal deficit.

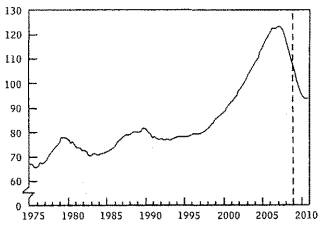
A major source of uncertainty in the outlook is the degree and persistence of turmoil in financial markets and the resulting impact on the future course of the economy. Many financial instruments and practices that contributed to the financial crisis came into widespread use only in the past decade, and the scale of the problems and the worldwide linkages of financial markets are significantly different from what they were in previous episodes of financial stress in the United States. Furthermore, the scale and novelty of federal intervention, particularly by the Federal Reserve, and uncertainty about the degree to which those interventions will affect the economic outlook, make it particularly difficult for analysts to use historical patterns to forecast the near future.

1. That calculation differs from CBO's estimate of the budgetary effects of all economic factors, primarily because it reflects only the direct effects of the business cycle, as measured by the deviation of GDP and unemployment from their potential levels. It does not include budgetary effects from changes in inflation and interest rates. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018* (January 2008), Box C-1.

Figure 2.

Inflation-Adjusted House Prices, 1975 to 2010

(Index, 2002 = 100)



Sources: Congressional Budget Office; Federal Housing Finance Agency; Department of Commerce, Bureau of Economic Analysis.

Notes: The index shown is the Federal Housing Finance Agency's purchase-only house price index for 1991 to the present and estimated values using the total index for previous years, divided by the personal consumption price index.

Data are quarterly and are plotted through the fourth quarter of 2010.

It is possible that the extensive support that the Federal Reserve and the Department of the Treasury have provided to banks and other financial institutions—and have promised to continue to provide—will soon restore a measure of confidence that will permit a rapid rebound in economic activity. Alternatively, greater declines in house prices than CBO anticipates may generate further losses on mortgage-backed securities. Because institutions' direct and indirect exposure to those securities is still not clear, banks may remain unwilling to lend to one another or to other, nonfinancial, customers, making it difficult for many households and businesses to obtain financing. Furthermore, foreign lenders, who have recently been willing to lend to the U.S. government on very advantageous terms, may become less willing to do so in the future, which would tend to raise interest rates in this country and dampen economic activity.

The Outlook from 2011 to 2019

CBO does not attempt to predict cyclical movements beyond the near term—that is, in the current projections, beyond 2010—but instead aims to describe an average path on which the economy's actual output gradually converges with its potential output.[2] In these projections, the anticipated GDP gap—the difference between actual and potential output—will not close until early 2015 (see Figure 1 on page 2). After that point, CBO projects, GDP will average close to its potential and therefore will grow at the same rate: 2.3 percent.

Inflation, as measured by the price index for personal consumption expenditures in the national income and product accounts (the inflation measure that the Federal Reserve watches most closely), averages 1.9 percent per year during the latter years of CBO's projections (2015 to 2019). That estimate implies a slightly higher growth rate, 2.2 percent, for the CPI-U and a slightly lower growth rate, 1.9 percent, for the overall GDP price index. The projected unemployment rate averages 4.8 percent during those years, equal to CBO's estimate of the average sustainable rate in the long run. The interest rate on 3-month Treasury bills is projected to average 4.7 percent, and the rate on 10-year Treasury notes, 5.4 percent.

The Housing Market

Although housing starts and house prices have fallen substantially, the inventory of unsold homes remains very high. The correction in the housing market will probably continue for most of this year.

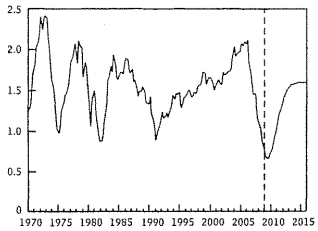
The volume of home construction started to fall early in 2006 when the number of vacant units started to increase and real prices of houses, which had been rapidly increasing, suddenly plateaued. In 2007, house prices started to fall and have continued to do so, with the worst of the decline concentrated in California, Florida, Arizona, and Nevada. According to CBO's forecast, the national average price of a house will fall by an additional 14 percent between the third quarter of 2008 and the middle of 2010. Because consumer prices are expected to grow less than 1 percent over that period, the real price of the average house falls by a similar amount (see Figure 2). Price changes in specific areas may be quite different, however.

2. A number of significant tax provisions originally enacted in 2001 and 2003 are scheduled to expire at the end of December 2010, which would affect economic growth. However, because CBO does not attempt to forecast cyclical developments more than two years ahead, it has not incorporated in its projections an estimate of the short-term restraint from the tax increase.

Figure 3.

Housing Starts, 1970 to 2015

(Millions, at an annual rate)



Sources: Congressional Budget Office; Department of Commerce, Bureau of the Census.

Notes: Housing starts include both single-family and multifamily homes.

Data are quarterly and are plotted through the fourth quarter of 2015.

The imbalance between the supply of and demand for housing persists, as reflected in unusually high vacancy rates and a low volume of housing starts (see Figure 3). The percentage of owned (as opposed to rented) units that were vacant and for sale jumped from a 20-year average of 1.7 percent between 1985 and 2005 to 2.8 percent in the third quarter of 2008. Largely because of that increase, housing starts dropped from an annual rate of 2.1 million in the summer of 2005 to 0.7 million at the end of 2008. CBO anticipates that housing starts will not begin to recover until late in 2009.

After rising for much of last year, mortgage rates—both for conforming loans (ones eligible to be purchased by the government-sponsored enterprises [GSEs] Fannie Mae and Freddie Mac) and larger, jumbo, loans—decreased late last year, particularly at the end of December (see Figure 4).[3] Lower mortgage rates have spurred applications for mortgage refinancing, but the number of applications for loans to finance home purchases remains low.

Foreclosure rates, however, are unusually high for all types of mortgages, particularly for subprime adjustable-rate mortgages (ARMs), putting more pressure on the financial system (see Figure 5). From early 2006 to the first half of 2008, foreclosures of properties with subprime ARMs jumped from the 2 percent average that had been experienced for eight years to 7 percent, although the percentage decreased slightly in the third quarter of 2008. Foreclosure rates are likely to remain high while house prices continue to fall and the economy remains in recession. Many homeowners have negative equity in their homes (that is, they owe more on their mortgage than the market value of their house) and will not be able to refinance their mortgage.[4]

Financial Markets

Financial markets have been under stress since August 2007, and the financial crisis deepened in the second half of 2008. In September 2008, with an ongoing decline in house prices, a slowing of real economic activity, and negative news about the state of several large financial institutions, financial markets appeared on the verge of freezing up, particularly the interbank market for short-term loans. A measure of that risk is the spread between the three-month London interbank offered rate (or Libor, the interest rate that major banks charge other banks for loans of that duration) and the three-month average of the expected federal funds rate (the Federal Reserve targets the federal funds rate in its conduct of monetary policy). That spread jumped sharply in the fall, reaching a record level of 3.6 percentage points on October 10 (see Figure 6). That increase reflected financial markets'

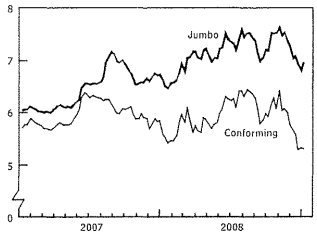
3. Those two large firms were originally created as federally chartered institutions but were privately owned and operated. Designed to facilitate the flow of investment funds to the housing market, they pool mortgages purchased from mortgage lenders and sell them as mortgage-backed securities, collecting annual guarantee fees on the mortgages they securitize. In return, Fannie Mae and Freddie Mac cover any losses that occur if the underlying mortgage loans default. The companies also hold mortgage loans in their portfolios and purchase mortgage-related securities (their own or those of other institutions), from which they earn a return.

4. Calculations of the number of households with negative equity vary from 7.8 million to 11.7 million households, amounting to a total of between $676 billion and $846 billion in outstanding loans. See Christopher Mayer and R. Glenn Hubbard, "House Prices, Interest Rates, and the Mortgage Market Meltdown" (working paper, Columbia Business School and the National Bureau of Economic Research, October 2008).

Figure 4.

Interest Rates on Mortgage Loans, January 2007 to January 2009

(Percent)



Sources: Congressional Budget Office; Bankrate.com.

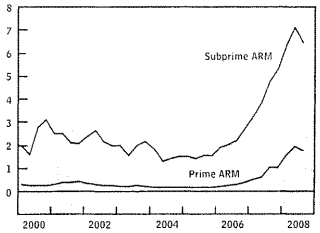
Notes: Conforming mortgage loans are those that can be purchased by Fannie Mae and Freddie Mac on the secondary loan market. Jumbo mortgage loans are all loans that are larger than conforming loans.

Data are weekly and are plotted through January 2, 2009.

Figure 5.

Foreclosure Rates, 2000 to 2008

(Percentage of loans)



Sources: Congressional Budget Office; Mortgage Bankers Association.

Notes: ARM = adjustable-rate mortgage.

Data are quarterly and are plotted through the third quarter of 2008.

greater uncertainty about the ability of banks to repay their loans.

The Federal Reserve has sought to reestablish the flow of funds in the economy, using a variety of mechanisms that, together, raised banks' reserves to $848 billion by the end of 2008 from $13 billion 12 months earlier and increased the Federal Reserve's overall balance sheet from $892 billion to $2,247 billion. The Federal Reserve cut its target for the federal funds rate from 5.25 percent in August 2007 to between zero and 0.25 percent in December and correspondingly lowered the discount rate (which is the rate that banks pay for borrowing from the Federal Reserve's discount window). However, even with short-term interest rates close to zero, the Federal Reserve has continued to provide additional support to credit markets using a strategy known as "quantitative easing." In doing so, the Federal Reserve has greatly extended its loan facilities, accepting as collateral assets that have been shunned by private lenders because of the heightened uncertainty. In addition, the Federal Reserve announced in late November plans to purchase, over the next few quarters, up to $100 billion in debt issued by Fannie Mae, Freddie Mac, and Ginnie Mae and up to $500 billion in mortgage-backed securities guaranteed by those entities.[5] As of late December, the Federal Reserve had purchased about $15 billion in debt issued by those entities.

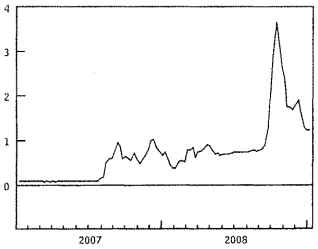
The Treasury also has intervened in the financial markets, mostly to improve the solvency of financial institutions. After failing to restore confidence in Fannie Mae and Freddie Mac with the Housing and Economic Recovery Act of 2008—which temporarily authorized the Treasury to purchase obligations and securities issued by the two entities—the government took control of them. In the fall of 2008, the Congress authorized the Troubled Asset Relief Program, which the Treasury used to provide $248 billion to financial institutions by the end of December, with the aim of helping to get credit flowing again. In addition, the Treasury will assist the automobile industry by making loans to General Motors and

5. Ginnie Mae, a government-owned corporation, guarantees securities backed by federally insured or guaranteed loans, mainly loans insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs.

Figure 6.

The Risk Spread on Lending Between Banks, January 2007 to January 2009

(Percentage points)



Sources: Congressional Budget Office; Bloomberg.

Notes: A spread is the difference between two interest rates. One, the three-month Libor (London interbank offered rate), is the interest rate major banks offer to other banks for loans of that duration. The other is the average federal funds rate expected over a three-month period as measured by the overnight index swap contract.

Data are weekly and are plotted through January 2, 2009.

Chrysler (and providing assistance to GMAC, a financial services company), with the goal of improving their long-term viability.

By the end of December 2008, some credit markets had improved, although the financial system remains strained. The spread between the Libor and the expected federal funds rate has dropped markedly from the very high levels observed in October 2008, but—at 1.2 percent—it remains unusually high. The spread between the interest rate on commercial paper, a kind of loan that plays a key role in providing short-term credit to both financial and nonfinancial businesses, and the three-month Treasury bill rate also dropped markedly in the last half of December 2008 (see Figure 7). However, in view of the high volatility of the markets in recent months, it is too early to determine whether the government's actions are having a permanent effect.

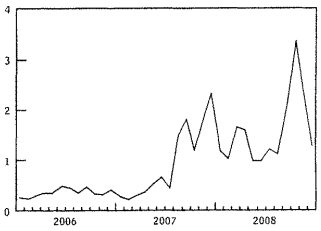
The stock market has plummeted in reaction to both the dismal news about the financial state of some firms and the downturn in economic activity. The Standard & Poor's 500 index fell by almost 45 percent from the peak in October 2007 to December 2008, and the value of stock in Fannie Mae and Freddie Mac fell almost to zero. The huge decline in equity wealth—of around $6 trillion between the end of 2007 and the end of 2008—is an important factor holding down households' spending.

The financial crisis has spread around the world. The credit squeeze has caused the governments of several industrialized countries to nationalize major banks or provide significant financial support to them. Gloomy economic outlooks have also pummeled equity markets in both industrial and emerging economies. In 2007, when emerging economies appeared to have weathered the initial stages of the crisis unfolding in industrial economies, there was hope that the relative vitality of emerging economies (such as those of China, India, and Brazil) would help moderate the downturn in the industrial world. That hope was dampened in 2008 as those economies weakened under the weight of falling exports and reversals of capital inflows. Despite bold initiatives

Figure 7.

A Risk Spread in the Commercial Paper Market, 2006 to 2008

(Percentage points)



Sources: Congressional Budget Office; Federal Reserve Board.

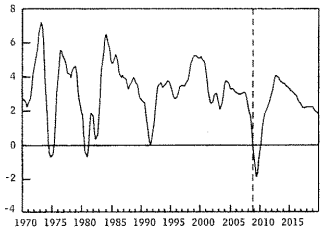
Notes: The spread is calculated as the difference between interest rates on AA asset-backed commercial paper and the three-month Treasury bill. The rate for commercial paper is that paid by the issuing institutions (primarily corporations).

Data are monthly and are plotted through December 2008.

Figure 8.

Real Personal Consumption Expenditures, 1970 to 2019

(Percentage change from previous year)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: Data are quarterly and are plotted through the fourth quarter of 2019.

announced by policymakers in industrial as well as emerging economies—for example, the large cuts in interest rates by the European Central Bank and the Bank of England and the large fiscal stimulus measure announced by the Chinese government—the outlook for the growth of economic activity worldwide is poor.

Personal Consumption Spending

Personal consumption spending sagged during the second half of last year because of three main factors: declining employment, large decreases in wealth, and tighter credit conditions (see Figure 8). Looking ahead, CBO anticipates that the rise in unemployment, lagged effects of declines in wealth, and tight consumer credit will continue to restrain consumption. Lower expenditures on petroleum imports, however, will act like a tax cut and will ease those effects somewhat (see Figure 9). CBO projects that real consumption will decrease by about 1.2 percent in 2009 and then grow moderately, by about 1.6 percent in 2010.

The looming increase in unemployment and its effect on real disposable income will severely restrict consumption growth. Employment is projected to fall by more than 2 percent in 2009 and the number of hours worked by more than 3 percent. Helped in part by falling energy prices, real disposable income is expected to grow by half a percent in 2009.

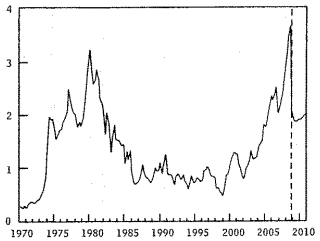
The decline in house prices and the drop in stock prices sharply reduced the net worth of households, by roughly 20 percent between the middle of 2007 and the fourth quarter of 2008. That decrease in wealth, in turn, is reducing spending on personal consumption. According to CBO's estimates, that wealth effect will subtract about 1 percentage point from the growth of personal consumption spending in 2009, after having reduced the growth of spending by almost the same amount in 2008.

The financial turmoil has also played a role in weakening households' spending by reducing the credit available to consumers, especially for those with limited borrowing opportunities or little collateral. The Federal Reserve's October 2008 survey of senior loan officers suggests that banks are not yet willing to resume extensive lending to consumers. Banks' willingness to make consumer loans has dropped to its lowest level since 1980 (see Figure 10).

Figure 9.

Petroleum Imports as a Percentage of Nominal GDP, 1970 to 2010

(Percent)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

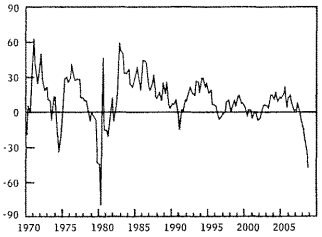
Notes: GDP = gross domestic product.

Data are quarterly and are plotted through the fourth quarter of 2010.

Figure 10.

Banks' Willingness to Lend, 1970 to 2008

(Net percentage)



Sources: Congressional Budget Office; Federal Reserve Board.

Notes: The figure shows the net percentage of respondents reporting a greater willingness to make consumer installment loans over the past three months in the Federal Reserve Board's *Senior Loan Officer Opinion Survey on Bank Lending Practices*.

Data are quarterly and are plotted through the fourth quarter of 2008.

By CBO's calculations, tight credit will subtract about 1.5 percentage points from consumption growth in 2009.

Changes in the Forecast Since the Summer of 2008

CBO has significantly changed its forecast from the one published in September 2008 (see Table 2). House prices contracted more than expected, equity prices fell, and the extent of the credit crunch in financial markets was unanticipated. The resulting loss of wealth—together with the lack of available credit—depressed consumption, employment, and GDP in the second half of 2008 by much more than CBO expected. Those developments indicated that the economic slowdown would be much more severe and more protracted than was previously anticipated. The new forecast shows lower growth of GDP, higher unemployment in subsequent years, lower commodity prices, lower investment, and lower inflation.

In the current forecast, the growth of real GDP is 3 percentage points lower in 2009 and 2 percentage points lower in 2010 than in the previous forecast. The projected average unemployment rate is 2 percentage points higher in 2009 and 3 percentage points higher in 2010. Lower commodity prices and excess productive capacity have dramatically lowered the expected growth of the CPI-U in 2009—to 0.1 percent, compared with the 3.1 percent forecast previously. The projected increase in the CPI-U in 2010 has been reduced from 2.2 percent to 1.7 percent.

CBO's projection for the growth of potential output—2.3 percent, on average, during the 10-year period—is one-tenth of a percentage point slower than its estimate from last summer. Therefore, in the current forecast, by 2018, real potential GDP is about 1 percentage point lower. That downward revision is driven largely by two developments: First, the projection for business investment is considerably lower than it was in the previous forecast, which lowers the projected rate of capital accumulation and the amount of capital goods that will be available for each worker. Second, the projection for potential total factor productivity (TFP)—the growth of output that is not explained by the growth in the inputs of labor and capital—is also lower. CBO forecasts that potential TFP will grow at an average annual rate of 1.3 percent during the 2009–2019 period, compared with the 1.4 percent rate anticipated last summer.[6]

The lingering effects of the recession lower inflation and interest rates in this forecast from 2011 to 2013, and as a result, the average inflation rate and the average interest rates over the whole 2011–2019 period are slightly lower than in the summer forecast. As in the summer forecast, the inflation forecast for the period after 2014 reflects the assumption that the Federal Reserve's monetary policy will achieve an average rate of inflation, measured by the personal consumption price index, of about 2 percent during those years.

Comparison with Other Forecasts

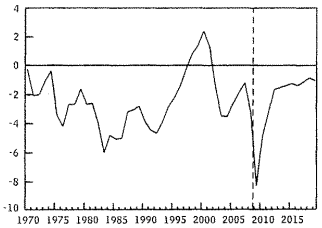
Comparing CBO's forecast with others, including the *Blue Chip* consensus (the average of about 50 forecasts by private-sector economists), is difficult because most of

6. That revision results from a reevaluation of the short-term surge in the growth of TFP earlier in the decade. CBO now treats more of that growth as transitory and therefore has lowered its estimate of the trend growth in TFP.

Figure 11.

The Total Deficit or Surplus as a Share of GDP, 1970 to 2019

(Percent)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: GDP = gross domestic product.

Data are for fiscal years, plotted through 2019.

them incorporate an assumption of substantial additional fiscal stimulus, while CBO's (following rules specified by law) does not.[7]

In CBO's forecast, the decline of 2.2 percent in real GDP in 2009 is greater than it is in the *Blue Chip* consensus forecast and in the average of the bottom 10 forecasts, which is a decline of 1.8 percent (see Table 3 on page 14). Although some of the forecasts within the *Blue Chip* are expecting slower growth in the CPI-U in 2009, the consensus estimate of overall inflation, 0.6 percent, is higher than CBO's estimate of 0.1 percent. The *Blue Chip* consensus expects an unemployment rate of 7.8 percent next year, which is one-half percent lower than CBO's projection. CBO expects lower interest rates for 3-month Treasury bills and for 10-year Treasury notes than do the survey participants.

7. In the December survey, participants in the *Blue Chip* consensus reported that they expected fiscal stimulus of between $400 billion and $800 billion; 52 percent of the respondents expected the figure to be $500 billion.

The Budget Outlook

The ongoing turmoil in the housing and financial markets has taken a major toll on the federal budget. CBO currently projects that the deficit this year will total $1.2 trillion, or 8.3 percent of GDP. That total, however, does not include the effects of any future legislation. Enactment of an economic stimulus package, for example, would add to the 2009 deficit. In any event, as a percentage of GDP, the deficit will most likely shatter the previous post-World War II record high of 6.0 percent posted in 1983 (see Figure 11).

A drop in tax revenues and increased federal spending (much of it related to the government's actions to address the crisis in the housing and financial markets) both contribute to the robust growth in this year's deficit. Compared with receipts last year, collections from corporate income taxes are anticipated to decline by 27 percent and individual income taxes by 8 percent; in normal economic conditions, they would both grow by several percentage points. In addition, the estimated deficit includes outlays of more than $180 billion to reflect the cost of transactions of the TARP.[8]

The projected deficit for 2009 also incorporates CBO's estimate of the cost to the federal government of the recent takeover of Fannie Mae and Freddie Mac. Because those entities were created and chartered by the government, are responsible for implementing certain government policies, and are currently under the direct control of the federal government, CBO has concluded that their operations should be reflected in the federal budget. Recognizing the cost of the takeover adds about $200 billion (in discounted present-value terms) to the deficit this year, reflecting the long-term net cost of the more than $5 trillion in credit guarantees issued and loans held by those entities at the start of the fiscal year. In addition, the cost of Fannie Mae's and Freddie Mac's new credit activity in 2009 will total $38 billion, CBO estimates.

The Administration's Office of Management and Budget (OMB) will ultimately determine the budgetary treatment of Fannie Mae and Freddie Mac. If it chose to continue to treat them as nongovernmental entities, CBO would estimate the 2009 deficit to total $966 billion

8. CBO's estimate of those outlays is the projected net cost of the program's transactions on a discounted present-value basis.

Table 2.

CBO's Current and Previous Economic Projections for Calendar Years 2008 to 2018

	Estimated	Forecast		Projected Annual Average	
	2008[a]	2009	2010	2011-2014	2015-2018
Nominal GDP (Billions of dollars)					
January 2009	14,304	14,241	14,591	18,211 [b]	21,617 [c]
September 2008	14,334	14,873	15,696	19,028 [b]	22,470 [c]
Nominal GDP (Percentage change)					
January 2009	3.6	-0.4	2.5	5.7	4.4
September 2008	3.8	3.8	5.5	4.9	4.2
Real GDP (Percentage change)					
January 2009	1.2	-2.2	1.5	4.0	2.5
September 2008	1.5	1.1	3.6	3.0	2.3
GDP Price Index (Percentage change)					
January 2009	2.4	1.8	0.9	1.6	1.9
September 2008	2.3	2.6	1.9	1.9	1.9
Consumer Price Index[d] (Percentage change)					
January 2009	4.1	0.1	1.7	2.1	2.2
September 2008	4.7	3.1	2.2	2.2	2.2
Unemployment Rate (Percent)					
January 2009	5.7	8.3	9.0	6.4	4.8
September 2008	5.4	6.2	6.1	4.9	4.8
Three-Month Treasury Bill Rate (Percent)					
January 2009	1.4	0.2	0.6	3.8	4.7
September 2008	1.9	2.7	4.4	4.7	4.7

Continued

(including anticipated purchases by the Treasury of equity in those two entities).

CBO's baseline projections are not intended to be a forecast of future budgetary outcomes; rather, they serve as a neutral benchmark that legislators and others can use to assess the potential effects of policy decisions. As such, CBO's baseline budget projections, like its economic projections, do not incorporate potential changes in policy. On that basis, CBO estimates that the deficit will decline substantially in 2010—to 4.9 percent of GDP (see Table 4 on page 15). Much of that decline will result from smaller outlays for Fannie Mae, Freddie Mac, and the TARP. In addition, CBO's projections incorporate a significant increase in revenues from the alternative minimum tax (AMT), reflecting the assumption that the exemption amounts for that tax will revert to previous levels (although they have been adjusted annually for the past several years).

In CBO's baseline, the projected deficit drops further over the following two years—to 3.3 percent in 2011 and 1.6 percent in 2012. That result is largely predicated on the assumption that certain tax provisions originally enacted in 2001 and 2003 will expire in December 2010, as currently scheduled.[9] Incorporating that assumption about tax policy boosts the projected growth in revenues to more than 10 percent per year in both 2011 and 2012.

CBO projects that revenues will increase and some spending will moderate or decline as the economy gradually improves over the next few years. By the latter part of the 10-year projection period, the estimated deficits fall to about 1 percent of GDP. For the 2009-2018 period (the 10-year period used in the previous baseline), CBO

9. Those provisions were originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003.

Table 2. Continued

CBO's Current and Previous Economic Projections for Calendar Years 2008 to 2018

	Estimated 2008[a]	Forecast 2009	Forecast 2010	Projected Annual Average 2011-2014	Projected Annual Average 2015-2018
Ten-Year Treasury Note Rate (Percent)					
January 2009	3.7	3.0	3.2	4.8	5.4
September 2008	3.9	4.4	5.1	5.4	5.4
Tax Bases (Billions of dollars)					
Economic profits					
January 2009	1,533	1,384	1,413	1,952 [b]	2,139 [c]
September 2008	1,605	1,586	1,663	2,090 [b]	2,505 [c]
Wages and salaries					
January 2009	6,548	6,551	6,740	8,344 [b]	9,916 [c]
September 2008	6,616	6,882	7,286	8,727 [b]	10,238 [c]
Tax Bases (Percentage of GDP)					
Economic profits					
January 2009	10.7	9.7	9.7	10.5	10.2
September 2008	11.2	10.7	10.6	10.9	11.1
Wages and salaries					
January 2009	45.8	46.0	46.2	45.8	45.9
September 2008	46.2	46.3	46.4	45.9	45.7
Memorandum:					
Real Potential GDP (Percentage change)					
January 2009	2.6	2.4	2.0	2.2	2.4
September 2008	2.6	2.5	2.4	2.4	2.3

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

Note: GDP = gross domestic product; percentage changes are measured from one year to the next.

a. Values as of December 10, 2008.

b. Level in 2014.

c. Level in 2018.

d. The consumer price index for all urban consumers.

is now projecting deficits that total about $1.8 trillion more than those projected in September 2008; about $1.0 trillion of that change occurs in 2009 and 2010. Primarily because of the change in the economic outlook, projected revenues over the 10-year period are, on average, about $280 billion a year lower. Projected outlays are also lower, however, mostly because they extrapolate the funding provided so far this year for operations in Iraq and Afghanistan, which is nearly $120 billion lower than the total of war-related appropriations for 2008. Additional supplemental appropriations for those purposes are anticipated later in the year.

The Budget Outlook for 2009

The federal fiscal situation in 2009 will be dramatically worse than it was in 2008. Under the assumption that current laws and policies remain in place (that is, not accounting for any new legislation), CBO estimates that the deficit this year will total $1.2 trillion, more than two and a half times the size of last year's. As a percentage of

Table 3.

Comparison of Economic Forecasts by CBO and the *Blue Chip* Consensus for Calendar Year 2009

	Estimated 2008	Forecast 2009
	Year to Year (Percentage Change)	
Nominal GDP		
CBO	3.6	-0.4
Blue Chip Consensus	3.5	0.7
Blue Chip High 10	3.7	1.8
Blue Chip Low 10	3.2	-0.7
Real GDP		
CBO	1.2	-2.2
Blue Chip Consensus	1.3	-1.1
Blue Chip High 10	1.3	-0.3
Blue Chip Low 10	1.2	-1.8
GDP Price Index		
CBO	2.4	1.8
Blue Chip Consensus	2.3	1.7
Blue Chip High 10	2.4	2.5
Blue Chip Low 10	2.0	0.5
Consumer Price Index		
CBO	4.1	0.1
Blue Chip Consensus	4.0	0.6
Blue Chip High 10	4.2	1.9
Blue Chip Low 10	3.8	-0.7
	Calendar Year Average (Percent)	
Unemployment Rate		
CBO	5.7	8.3
Blue Chip Consensus	5.7	7.8
Blue Chip High 10	5.8	8.3
Blue Chip Low 10	5.7	7.4
Three-Month Treasury Bill Rate		
CBO	1.4	0.2
Blue Chip Consensus	1.4	0.7
Blue Chip High 10	1.5	1.1
Blue Chip Low 10	1.2	0.2
Ten-Year Treasury Note Rate		
CBO	3.7	3.0
Blue Chip Consensus	3.7	3.4
Blue Chip High 10	3.8	4.1
Blue Chip Low 10	3.6	2.7

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; and Aspen Publishers, Inc., *Blue Chip Economic Indicators* (December 10, 2008).

Notes: GDP = gross domestic product.

The *Blue Chip* consensus is the average of about 50 forecasts by private-sector economists. The latest *Blue Chip* consensus does not extend past 2009.

Table 4.

Projected Deficits and Surpluses in CBO's Baseline

(Billions of dollars)

	Actual 2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total, 2010-2014	Total, 2010-2019
On-Budget Deficit	-638	-1,340	-843	-641	-412	-413	-411	-398	-434	-393	-342	-381	-2,721	-4,668
Off-Budget Surplus[a]	183	155	140	143	149	156	162	164	162	159	154	146	749	1,534
Total Deficit	-455	-1,186	-703	-498	-264	-257	-250	-234	-272	-234	-188	-235	-1,972	-3,135
Memorandum:														
Total Deficit as a Percentage of GDP	-3.2	-8.3	-4.9	-3.3	-1.6	-1.5	-1.4	-1.2	-1.4	-1.1	-0.9	-1.1	-2.4	-1.7
Debt Held by the Public as a Percentage of GDP[b]	40.8	50.5	54.2	54.4	52.8	50.0	48.6	47.3	46.4	45.5	42.7	41.9	n.a.	n.a.
Net Subsidy Costs for Fannie Mae and Freddie Mac as Government Entities Included in Baseline Projections	0	238	20	14	8	6	3	4	4	4	4	4	52	71
Cash Infusions from the Treasury to Fannie Mae and Freddie Mac[c]	0	18	18	19	17	13	8	3	0	0	0	0	75	78
Projected Deficits If Fannie Mae and Freddie Mac Were Not Included in the Budget as Federal Entities	-455	-966	-700	-503	-272	-264	-255	-234	-268	-230	-184	-231	-1,995	-3,142

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

Notes: GDP = gross domestic product; n.a. = not applicable.

Debt issued by Fannie Mae and Freddie Mac is not included in debt held by the public.

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

b. Debt held at the end of the year.

c. Under CBO's proposed treatment of showing the two government-sponsored enterprises (GSEs) within the budget, injections of cash equity from the Treasury to the GSEs would be intragovernmental transfers.

Table 5.

CBO's Baseline Budget Projections

	Actual 2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total, 2010-2014	Total, 2010-2019
	In Billions of Dollars													
Revenues														
Individual income taxes	1,146	1,060	1,199	1,396	1,572	1,726	1,853	1,978	2,099	2,227	2,347	2,475	7,745	18,870
Corporate income taxes	304	223	252	290	333	343	334	347	347	349	353	355	1,553	3,304
Social insurance taxes	900	915	938	978	1,032	1,087	1,141	1,192	1,242	1,294	1,347	1,403	5,176	11,653
Other	173	160	144	162	187	197	216	229	241	253	262	272	906	2,164
Total Revenues	**2,524**	**2,357**	**2,533**	**2,825**	**3,124**	**3,353**	**3,544**	**3,746**	**3,929**	**4,122**	**4,309**	**4,505**	**15,380**	**35,991**
On-budget	1,866	1,686	1,846	2,111	2,372	2,561	2,710	2,873	3,019	3,173	3,320	3,476	11,600	27,461
Off-budget	658	672	687	714	752	793	834	873	910	949	989	1,029	3,780	8,530
Outlays														
Mandatory spending	1,597	2,164	1,857	1,914	1,906	2,033	2,156	2,288	2,458	2,572	2,684	2,890	9,865	22,758
Discretionary spending	1,133	1,184	1,188	1,189	1,193	1,220	1,246	1,274	1,308	1,335	1,362	1,399	6,036	12,714
Net interest	249	195	191	220	289	358	392	418	434	448	452	451	1,450	3,654
Total Outlays	**2,978**	**3,543**	**3,236**	**3,323**	**3,388**	**3,610**	**3,794**	**3,980**	**4,201**	**4,355**	**4,497**	**4,740**	**17,351**	**39,126**
On-budget	2,504	3,026	2,689	2,752	2,784	2,973	3,121	3,271	3,453	3,565	3,663	3,857	14,320	32,129
Off-budget	475	517	547	571	604	637	672	709	748	790	835	883	3,031	6,997
Deficit (-) or Surplus	**-455**	**-1,186**	**-703**	**-498**	**-264**	**-257**	**-250**	**-234**	**-272**	**-234**	**-188**	**-235**	**-1,972**	**-3,135**
On-budget	-638	-1,340	-843	-641	-412	-413	-411	-398	-434	-393	-342	-381	-2,721	-4,668
Off-budget	183	155	140	143	149	156	162	164	162	159	154	146	749	1,534
Debt Held by the Public	5,803	7,193	7,829	8,238	8,475	8,516	8,734	8,925	9,149	9,335	9,127	9,344	n.a.	n.a.
Memorandum:														
Gross Domestic Product	14,224	14,257	14,452	15,137	16,048	17,035	17,986	18,864	19,703	20,537	21,397	22,278	80,659	183,438
	As a Percentage of Gross Domestic Product													
Revenues														
Individual income taxes	8.1	7.4	8.3	9.2	9.8	10.1	10.3	10.5	10.7	10.8	11.0	11.1	9.6	10.3
Corporate income taxes	2.1	1.6	1.7	1.9	2.1	2.0	1.9	1.8	1.8	1.7	1.6	1.6	1.9	1.8
Social insurance taxes	6.3	6.4	6.5	6.5	6.4	6.4	6.3	6.3	6.3	6.3	6.3	6.3	6.4	6.4
Other	1.2	1.1	1.0	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.1	1.2
Total Revenues	**17.7**	**16.5**	**17.5**	**18.7**	**19.5**	**19.7**	**19.7**	**19.9**	**19.9**	**20.1**	**20.1**	**20.2**	**19.1**	**19.6**
On-budget	13.1	11.8	12.8	13.9	14.8	15.0	15.1	15.2	15.3	15.4	15.5	15.6	14.4	15.0
Off-budget	4.6	4.7	4.8	4.7	4.7	4.7	4.6	4.6	4.6	4.6	4.6	4.6	4.7	4.7
Outlays														
Mandatory spending	11.2	15.2	12.9	12.6	11.9	11.9	12.0	12.1	12.5	12.5	12.5	13.0	12.2	12.4
Discretionary spending	8.0	8.3	8.2	7.9	7.4	7.2	6.9	6.8	6.6	6.5	6.4	6.3	7.5	6.9
Net interest	1.7	1.4	1.3	1.5	1.8	2.1	2.2	2.2	2.2	2.2	2.1	2.0	1.8	2.0
Total Outlays	**20.9**	**24.9**	**22.4**	**22.0**	**21.1**	**21.2**	**21.1**	**21.1**	**21.3**	**21.2**	**21.0**	**21.3**	**21.5**	**21.3**
On-budget	17.6	21.2	18.6	18.2	17.3	17.5	17.4	17.3	17.5	17.4	17.1	17.3	17.8	17.5
Off-budget	3.3	3.6	3.8	3.8	3.8	3.7	3.7	3.8	3.8	3.8	3.9	4.0	3.8	3.8
Deficit (-) or Surplus	**-3.2**	**-8.3**	**-4.9**	**-3.3**	**-1.6**	**-1.5**	**-1.4**	**-1.2**	**-1.4**	**-1.1**	**-0.9**	**-1.1**	**-2.4**	**-1.7**
On-budget	-4.5	-9.4	-5.8	-4.2	-2.6	-2.4	-2.3	-2.1	-2.2	-1.9	-1.6	-1.7	-3.4	-2.5
Off-budget	1.3	1.1	1.0	0.9	0.9	0.9	0.9	0.9	0.8	0.8	0.7	0.7	0.9	0.8
Debt Held by the Public	40.8	50.5	54.2	54.4	52.8	50.0	48.6	47.3	46.4	45.5	42.7	41.9	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

GDP, the deficit this year will total 8.3 percent (as compared with 3.2 percent in 2008)—the largest since 1945.

The deterioration in the fiscal picture results from both increased outlays and decreased revenues. Relative to what they were last year, outlays will rise dramatically—by 19 percent according to CBO's estimates. Much of that increase is a result of policy responses to the turmoil in the housing and financial markets—particularly spending for the TARP and the conservatorship of Fannie Mae and Freddie Mac.[10] In addition, economic developments have reduced tax receipts (particularly from individual and corporate income taxes) and boosted spending on programs such as those providing unemployment compensation and nutrition assistance as well as those with cost-of-living adjustments.

Outlays. Without changes in current laws and policies, CBO estimates, outlays will rise from $3.0 trillion in 2008 to $3.5 trillion in 2009 (see Table 5). Mandatory spending is projected to grow by almost $570 billion, or by 36 percent; nearly three-quarters of that growth results from the activities of the TARP and CBO's treatment of Fannie Mae and Freddie Mac as federal entities. Discretionary spending is projected to grow by $52 billion, or by 4.6 percent. In contrast, net interest is anticipated to decline by 22 percent as a result of lower interest rates and lower inflation. In total, outlays will be equal to 24.9 percent of GDP, a level exceeded only during the later years of World War II.

CBO estimates that incorporating the two housing GSEs into the federal budget would add nearly $240 billion to outlays in 2009.[11] Most of that amount results from a one-time expense—the long-term net cost of taking on Fannie Mae's and Freddie Mac's portfolios of mortgage loans and guarantees.[12]

Assuming that the TARP eventually disburses the full $700 billion that was specified in the legislation that created the program, CBO has estimated outlays of more than $180 billion for 2009 to account for the subsidy costs related to those investments and loans.[13]

Spending for certain other mandatory programs is expected to rise sharply this year. The faltering economy has increased outlays for unemployment compensation and the Supplemental Nutrition Assistance Program. Unemployment compensation is projected to nearly double—from $43 billion last year to $79 billion this year—as a result of increased unemployment and legislation to date extending such benefits. Outlays for the nutrition assistance program are expected to grow by 27 percent—from $39 billion to $50 billion—primarily because of increases in caseloads and benefits (resulting from higher food prices).

The three largest mandatory programs—Social Security, Medicare, and Medicaid—are all anticipated to record growth of at least 8 percent this year. Some of that growth stems from the relatively high rate of inflation recorded early in 2008, which boosted cost-of-living adjustments for retirees and the cost of health care. In addition, rising unemployment will add to Medicaid spending by increasing the number of beneficiaries.

Discretionary spending under current laws and policies is projected to grow by 4.6 percent in 2009. In CBO's baseline, defense outlays rise by 5.0 percent and nondefense outlays by 4.1 percent. However, most programs are currently operating under a continuing resolution, which holds funding for 2009 at the level provided for 2008. Final appropriations and additional funding for operations in Iraq and Afghanistan may increase outlays for 2009 and beyond, and any stimulus package may raise discretionary spending further.

Even though the amount of debt held by the public is projected to grow by nearly $1.4 trillion this year (exclud-

10. Conservatorship is the legal process in which an entity is appointed to establish control and oversight of a company to put it in a sound and solvent condition.

11. Another housing-related GSE, the Federal Home Loan Bank System (FHLB), which provides low-cost loans to home mortgage lenders, has not been taken over by the government. However, some of the FHLB's activities, specifically those related to affordable housing, are recorded in the federal budget.

12. CBO's calculations related to Fannie Mae and Freddie Mac are done by estimating the present value of all future cash flows, including an adjustment for market risk.

13. CBO's calculation of the cost of the TARP has been done by estimating the present value of all future cash flows, including an adjustment for market risk (as specified by the Emergency Economic Stabilization Act of 2008, Division A of Public Law 110-343). Thus far, the Administration is accounting for capital purchases made under the TARP on a cash basis rather than on the present-value basis that was specified in the law. That treatment will show more outlays for the TARP this year and then substantial receipts in future years.

ing any effects of future legislation), net interest payments are projected to decline by more than 20 percent. Short-term interest rates on federal debt have plummeted to near zero in recent months, and long-term rates have fallen by 100 basis points since last summer.[14] Such low rates have substantially reduced the near-term cost of borrowing. In addition, the lower inflation forecast for the current year has reduced the projected cost of interest on the Treasury's inflation-protected securities by $35 billion relative to what it was last year.

Revenues. CBO expects federal revenues under current laws and policies to total $2.4 trillion this fiscal year, a decline of $166 billion, or 6.6 percent, from the amount in 2008. The combination of the recession and sharp drops in the value of assets—most significantly in publicly traded stock—is expected to lead to sizable declines in receipts from individual and corporate income taxes and, to a much lesser extent, from estate and gift taxes. Receipts from individual income taxes are projected to decline this year by $86 billion, or by 8 percent, and receipts from corporate income taxes by $81 billion, or by 27 percent. In CBO's baseline, an increase in social insurance (payroll) tax receipts of $14 billion, or 2 percent, offsets a small portion of the projected overall decline in revenues.

As a share of GDP, revenues are projected to decline from 17.7 percent in 2008 to 16.5 percent in 2009—about the share recorded in 2003 and 2004 but otherwise the lowest since 1959. Typically, revenues as a percentage of GDP drop in recessions, and CBO expects the decline to be especially pronounced this year as a result of the sharp fall in asset prices and in taxable corporate profits.[15]

The substantial decline in the stock market is expected to sharply reduce revenues in 2009 from a variety of sources: realizations of capital gains by individuals and corporations; distributions by individuals from their tax-deferred retirement accounts, such as 401(k)s and individual retirement accounts; and estate and gift taxes. The largest of those effects is concentrated in receipts from individual income taxes. Tax liabilities from individuals' realized capital gains are projected to drop in tax year 2008 by about $55 billion, or by more than 40 percent, mostly affecting federal receipts in 2009.

Declines in corporate capital gains represent just a portion of the expected weakness in corporate receipts. CBO expects profits of corporations to decline substantially because, as in most recessions, income from their sales and investments will drop faster than their costs of paying workers, paying interest on debt, and depreciating their equipment and structures. For tax year 2008, CBO also expects a substantial increase in tax deductions for bad debts, which include loans that businesses make that they can no longer collect. In addition, steep 2008 losses in the financial industry, which was very profitable in 2006 and 2007, mean that many firms in that sector will be able to apply those losses to the earlier profits and receive refunds of the income taxes they previously paid; those refunds will reduce receipts from corporate income taxes in 2009.[16]

Federal Debt. In most years, the amount of debt that the Treasury issues roughly equals the annual budget deficit, although a number of other factors also affect the government's need to borrow money from the public. In a typical year, those factors might total $10 billion to $30 billion. However, the Treasury's actions aimed at stabilizing the financial markets added more than $300 billion to the Treasury's borrowing needs in 2008 (on top of the borrowing necessary to finance the budget deficit) and will boost them by about an estimated $200 billion in 2009 (see Table 6).

In 2008, the Treasury borrowed about $300 billion to deposit at the Federal Reserve to help it finance initiatives to enhance liquidity in the credit markets. CBO anticipates that the Treasury will withdraw those balances later this year, thereby reducing borrowing needs for 2009 by the amount deposited last year.

14. A basis point is one-hundredth of a percentage point.

15. The projected decline in revenues for 2009 is greater when receipts are compared with those in 2008 excluding the direct effect of tax rebates sent to individuals under the Economic Stimulus Act of 2008; those rebates reduced revenues in 2008 by about 0.4 percent of GDP.

16. Under current law, firms with losses generally can receive refunds of income taxes paid in the two previous years.

Table 6.

CBO's Baseline Projections of Federal Debt

(Billions of dollars)

	Actual 2008[a]	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Debt Held by the Public at the Beginning of the Year	5,035	5,803	7,193	7,829	8,238	8,475	8,516	8,734	8,925	9,149	9,335	9,127
Changes to Debt Held by the Public												
Deficit	455	1,186	703	498	264	257	250	234	272	234	188	235
Other means of financing												
TARP[b]	0	461	-20	-91	-33	-218	-31	-31	-31	-31	-378	0
Fannie Mae and Freddie Mac[c]	0	-221	-6	-1	2	-1	-4	-10	-13	-13	-13	-14
MBS purchase program[b]	5	248	-23	-23	-23	-23	-23	-23	-23	-23	-23	-23
Change in cash balances	296	-297	-40	0	0	0	0	0	0	0	0	0
Other	12	13	23	26	27	27	26	22	20	20	19	19
Subtotal	313	204	-67	-89	-27	-215	-32	-42	-48	-48	-396	-18
Total	**768**	**1,390**	**636**	**410**	**236**	**42**	**217**	**192**	**224**	**185**	**-208**	**217**
Debt Held by the Public at the End of the Year	**5,803**	**7,193**	**7,829**	**8,238**	**8,475**	**8,516**	**8,734**	**8,925**	**9,149**	**9,335**	**9,127**	**9,344**
Debt Held by Government Accounts												
Social Security	2,366	2,524	2,668	2,814	2,964	3,119	3,281	3,445	3,607	3,766	3,919	4,065
Other[d]	1,817	1,812	1,826	1,872	1,971	2,074	2,173	2,268	2,336	2,406	2,486	2,564
Total	4,183	4,336	4,494	4,686	4,935	5,193	5,454	5,712	5,943	6,172	6,405	6,629
Gross Federal Debt	9,986	11,529	12,323	12,924	13,410	13,710	14,188	14,638	15,092	15,506	15,532	15,973
Debt Subject to Limit[e]	9,960	11,502	12,296	12,898	13,383	13,684	14,162	14,612	15,066	15,481	15,506	15,947
Memorandum:												
Debt Held by the Public at the End of the Year as a Percentage of GDP	40.8	50.5	54.2	54.4	52.8	50.0	48.6	47.3	46.4	45.5	42.7	41.9

Source: Congressional Budget Office.

Notes: TARP = Troubled Asset Relief Program; MBS = mortgage-backed security; GDP = gross domestic product.

Debt issued by Fannie Mae and Freddie Mac is not included in any of the above figures.

a. Preliminary.

b. Transactions related to the TARP and purchases of MBSs are accounted for in CBO's budget estimates using procedures similar to those used for federal credit programs. However, borrowing requirements are based on the cash flows of those programs.

c. CBO's calculations of federal borrowing requirements do not include the net subsidy costs for Fannie Mae and Freddie Mac. However, the calculations do include cash infusions from the Treasury.

d. Mainly Civil Service Retirement and Disability, Military Retirement, Medicare, and Unemployment Insurance Trust Funds.

e. Differs from the gross federal debt primarily because it excludes most debt issued by agencies other than the Treasury and the Federal Financing Bank. The current debt limit is $11.315 billion.

In the other direction, the cash flows for two programs will lift the Treasury's borrowing needs by more than $700 billion. For the TARP, CBO's baseline includes outlays of about $180 billion for 2009, but the Treasury is likely to have to borrow $460 billion more than that to cover the capital purchases, loans, and other activities of the program this year.[17] Additionally, the Treasury is purchasing mortgage-backed securities from the private market; CBO assumes that such purchases will total nearly $250 billion this year, thereby necessitating additional borrowing of a similar amount (although the budgetary impact of the purchases, shown as an estimated subsidy amount in 2009, is relatively small).

One other factor affects the gap between the projected deficit and anticipated borrowing. Although CBO is treating Fannie Mae and Freddie Mac as part of the federal budget, most of the cost recorded for 2009 reflects a present-value calculation rather than a cash outflow; consequently, the projected deficit overstates borrowing requirements in that respect by about $220 billion.

The Budget Outlook for 2010 to 2019

Under the assumptions that CBO uses for its baseline, the budget deficit would fall to about $700 billion in 2010. Revenues would increase by $176 billion that year, rebounding from declines in the previous two years. Outlays would be substantially lower than in 2009, largely because of the projected drop in outlays recorded for the TARP and for the subsidy costs related to Fannie Mae and Freddie Mac; with those two factors excluded, outlays would grow by 2.8 percent in 2010.

At 4.9 percent of GDP, the deficit in 2010 would be significantly lower than the one for this year but about twice as high as the average deficit over the past 40 years. Under current laws and policies, CBO projects, the deficit would fall to 3.3 percent of GDP in 2011, when certain tax provisions originally enacted in 2001 and 2003 are scheduled to expire, and to 1.6 percent in 2012, when the full effect of those expirations on revenues occurs. The decline in the deficit would be greater in those years but for the likelihood that interest rates will rise in conjunction with economic recovery, thereby boosting interest payments. Over the following few years, the deficits projected in CBO's baseline decline slightly from the level in 2012; by 2019, under the assumptions used for the baseline, the deficit would represent about 1.1 percent of GDP.

Outlays. Under the assumptions governing the construction of CBO's baseline, total outlays would decline from this year's level of 24.9 percent of GDP. By 2012, outlays would total 21.1 percent of GDP and would stay around that level through 2019, although they would increase by about 5 percent per year in nominal terms over that period. That increase is expected to result from higher interest costs and from the continued growth of Medicare and Medicaid at a pace significantly faster than the rate of growth of the economy. In contrast, discretionary spending is assumed to grow much more slowly—at the rate of inflation—as specified in the rules for producing baseline projections.

Net interest costs are projected to change little from 2009 to 2010, as interest rates are expected to remain relatively low. However, such costs are projected to grow rapidly over the next several years as a result of extraordinarily large accumulations of debt over the 2008–2011 period and an anticipated rise in rates beginning in 2011. Debt held by the public, which was $5.0 trillion at the end of fiscal year 2007, already exceeds $6 trillion, and under CBO's baseline projections, would grow to $8.2 trillion by the end of 2011. In the baseline, the government's interest payments grow by 16 percent in 2011, 31 percent in 2012, and 24 percent in 2013 before leveling off near the end of the 10-year projection period.

In CBO's baseline, the growth of both Medicare and Medicaid averages about 7 percent annually from 2010 through 2019. Under current law, Medicare outlays will be constrained in 2010 and subsequent years by the rate-setting system (the "sustainable growth rate") that controls the fees paid for physicians' services. Under that system, CBO projects, those fees will be reduced by about 21 percent in 2010 and by additional amounts thereafter. If legislation was enacted to override those reductions (as has happened in every year since 2003), spending on Medicare would be significantly greater than is projected in CBO's baseline. For example, if the scheduled reductions in physicians' fees were delayed one year so that payment rates in 2010 remained at the 2009 level (before dropping roughly 25 percent in 2011), outlays would increase by $12 billion in 2010 and by a total of $14 billion over the 2010–2019 projection period. Maintaining

17. CBO assumes that the TARP will also disburse about $20 billion in 2010 and that dividend payments received by the Treasury will offset some borrowing needs this year and in the future.

the 2009 payment rates through 2019 would add $324 billion in outlays over that period.

Total discretionary outlays, as projected in the baseline, grow at an average annual rate of 1.8 percent, rising from $1.2 trillion next year to $1.4 trillion in 2019. Such projections are based on the assumption that discretionary funding grows at specified rates of inflation and reflect the most recent funding provided. Relative to GDP, discretionary outlays fall from 8.2 percent in 2010 to 6.3 percent in 2019; at that point, defense outlays would, as a share of GDP, be at about the level that they were in 2001, but nondefense discretionary outlays would be lower than at any point in the past 40 years.

Revenues. After 2009, receipts are projected to begin growing again as the economy recovers and certain scheduled changes in tax law take effect. In CBO's baseline, revenues are projected to rise by 7.5 percent in 2010; over 40 percent of that growth stems from the assumed expiration of temporary relief from the AMT. For both 2011 and 2012, revenues are projected to increase by more than 10 percent; roughly half of that increase is attributable to the scheduled expiration of reductions in the individual income and estate taxes enacted in 2001 and 2003.

Under current laws and policies, revenues would grow faster than GDP in every year after 2009: They would reach 19.5 percent of GDP in 2012 and continue to rise, to 20.2 percent by 2019, the highest level since 2000. Since World War II, revenues have reached or exceeded 20.0 percent of GDP only three times—each year from 1998 to 2000.

In the baseline, most of the projected increase in revenues relative to GDP stems from individual income taxes. In addition to the effects that scheduled changes in tax law have over the 2010–2012 period, revenues from individual income taxes increase faster than GDP each year after 2009 because of three factors: the phenomenon known as real bracket creep, in which the overall growth of real income causes more income to be taxed in higher tax brackets; increases in revenues from the AMT, which will affect more taxpayers over time because it is not indexed for inflation, unlike important parts of the regular income tax; and increases in taxable distributions from tax-deferred retirement accounts as the population ages.

Federal revenues include remittances to the Treasury from the Federal Reserve, based on the latter's earnings. Until recently, those earnings consisted largely of interest on Treasury securities held for the conduct of monetary policy; the Federal Reserve paid no interest on its currency issues or the deposited reserves of banks. In response to the turmoil in the financial markets, the Federal Reserve's portfolio has expanded significantly in recent months through various loans and asset acquisitions; those assets now generate earnings for the Federal Reserve but also pose some risk of losses if the firms involved fail or if the posted collateral is insufficient to cover the losses. The Federal Reserve now pays interest on both required and excess reserves—the latter much increased as a part of the portfolio expansion—which reduces its earnings. Relative to previous projections, CBO's current estimates of the Federal Reserve's earnings are very similar for 2009 and lower for 2010 through 2018 by a total of about $90 billion. After 2009, the earnings-increasing effects of a larger portfolio will be insufficient to cover the earnings-reducing effects of lower interest rates, expected losses on the portfolio, and the payment of interest on reserves.[18]

Budget Projections Under Alternative Scenarios

To illustrate how different fiscal policies might affect the baseline, CBO estimated the budgetary impact of some alternative policy actions (see Table 7). The discussion below focuses on their direct effects on revenues and outlays; such changes would also affect projected debt-service costs (which are shown separately in Table 7).

Activities Related to Operations in Iraq and Afghanistan and the War on Terrorism. CBO's projections of discretionary spending for future years include outlays for operations in Iraq and Afghanistan and for other activities related to the war on terrorism; those outlays arise from funding provided in 2008 and prior years, from the $68 billion already provided for 2009, and from the $744 billion in budget authority for those purposes that is projected over the 2010–2019 period (under an assumption that funding each year is set at $68 billion plus adjustments for inflation). However, the funding provided for 2009 represents only a portion of what will be needed for those operations throughout this year and probably does not indicate the likely amount of spending in future years.

18. Beyond 2013, the reduction in projected revenues becomes less significant, with the remaining effect stemming largely from lower interest rates on long-term Treasury securities purchased by the Federal Reserve in the near term and held to maturity.

Table 7.

The Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline

(Billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total, 2010-2014	Total, 2010-2019
	Policy Alternatives That Affect Discretionary Spending												
Reduce the Number of Troops Deployed for Military Operations in Iraq and Afghanistan and Other Activities Related to the War on Terrorism to 30,000 by 2011[a]													
Effect on the deficit[b]	-24	-24	-1	19	30	37	41	42	45	45	47	62	281
Debt service	*	*	-1	-1	*	1	3	5	8	10	13	-2	37
Reduce the Number of Troops Deployed for Military Operations in Iraq and Afghanistan and Other Activities Related to the War on Terrorism to 75,000 by 2013[c]													
Effect on the deficit[b]	-26	-50	-63	-44	-21	-7	-1	3	6	6	6	-184	-165
Debt service	0	-1	-2	-5	-8	-10	-11	-12	-12	-13	-13	-26	-87
Increase Regular Discretionary Appropriations at the Rate of Growth of Nominal GDP[d]													
Effect on the deficit[b]	0	3	-16	-50	-91	-134	-173	-209	-241	-275	-308	-288	-1,494
Debt service	0	*	*	-1	-5	-11	-19	-30	-43	-58	-76	-18	-244
Freeze Total Discretionary Appropriations at the Level Provided for 2009													
Effect on the deficit[b]	0	14	31	51	76	103	132	162	192	222	256	275	1,240
Debt service	0	*	1	2	6	11	18	26	36	49	63	20	212
	Policy Alternatives That Affect the Tax Code[e]												
Extend EGTRRA and JGTRRA[f]													
Effect on the deficit[b]	*	-3	-132	-228	-257	-269	-280	-291	-302	-313	-325	-889	-2,400
Debt service	*	*	-1	-8	-22	-37	-54	-71	-90	-110	-131	-69	-525
Extend Other Expiring Tax Provisions													
Effect on the deficit[g]	-3	-21	-35	-52	-57	-62	-65	-69	-72	-75	-80	-227	-588
Debt service	*	*	-1	-3	-6	-10	-14	-18	-22	-27	-33	-20	-133
Index the AMT for Inflation[g]													
Effect on the deficit[h]	-7	-81	-58	-31	-37	-44	-52	-62	-72	-83	-97	-251	-617
Debt service	*	-1	-2	-5	-8	-11	-15	-19	-23	-28	-34	-27	-146

Continued

Table 7. Continued

The Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline

(Billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total, 2010-2014	Total, 2010-2019
Memorandum:													
Interactive Effect of Extending EGTRRA and JGTRRA and Indexing the AMT[g]													
Effect on the deficit[b]	0	0	-16	-52	-59	-67	-74	-82	-88	-95	-102	-194	-635
Debt service	0	0	*	-1	-4	-8	-12	-17	-22	-28	-34	-14	-126
Total Discretionary Outlays in CBO's Baseline	1,184	1,188	1,189	1,193	1,220	1,246	1,274	1,308	1,335	1,362	1,399	6,036	12,714
Total Outlays for Operations in Iraq and Afghanistan in CBO's Baseline	144	109	84	74	73	73	74	75	77	78	80	413	797
Total Deficit in CBO's Baseline	-1,186	-703	-498	-264	-257	-250	-234	-272	-234	-188	-235	-1,972	-3,135

Sources: Congressional Budget Office; Joint Committee on Taxation.

Note: GDP = gross domestic product; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003; AMT = alternative minimum tax; * = between -$500 million and $500 million.

a. This alternative does not extrapolate the $68 billion in funding for military operations and associated costs in Iraq and Afghanistan provided for 2009. However, it incorporates the assumption that an additional $82 billion in budget authority will be provided in 2009 to carry out operations in those countries. Future funding for operations in Iraq, Afghanistan, or elsewhere would total $92 billion in 2010, $42 billion in 2011, and then about $32 billion a year from 2012 on—for a total of $388 billion over the 2010–2019 period.

b. Excluding debt service.

c. This alternative does not extrapolate the $68 billion in funding for military operations and associated costs in Iraq and Afghanistan provided for 2009. However, it incorporates the assumption that an additional $87 billion in budget authority will be provided in 2009 to carry out operations in those countries. Future funding for operations in Iraq, Afghanistan, or elsewhere would total $149 billion in 2010, $129 billion in 2011, $95 billion in 2012, and about $70 billion a year from 2013 on—for a total of $867 billion over the 2010–2019 period.

d. Under this alternative, appropriations for 2009 for operations in Iraq and Afghanistan (as well as other emergency appropriations) are extrapolated according to rules for the baseline.

e. When this report went to press, the Joint Committee on Taxation's (JCT's) most recent estimates of the effects of extending expiring tax provisions were based on CBO's baseline projections from February 2008, updated for laws enacted through August 2008. Therefore, CBO has adjusted those estimates to take into account its updated economic projections and recent changes in law. JCT is currently updating its estimates to reflect CBO's new projections, and CBO will make those estimates available when they are completed.

f. These estimates do not include the effects of extending the increased exemption amount or the treatment of personal credits for the AMT that expired at the end of 2008. The effects of that alternative are shown separately.

g. This alternative incorporates the assumption that the exemption amount for the AMT (which was increased through 2008 in PL. 110-343) is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2008. In addition, the treatment of personal credits against the AMT (which was also extended through the end of 2008) is assumed to be extended. The estimates shown are relative to figures under current law. If this alternative was enacted jointly with the extension of the expiring tax provisions, an interactive effect would occur after 2010 that would make the combined revenue loss over the 2011–2019 period greater than the sum of the two separate estimates by $635 billion (plus $126 billion in debt-service costs).

In subsequent years, the annual funding required for military operations in Iraq and Afghanistan or in other locations may eventually be less than the amounts in the baseline if the number of troops and pace of operations diminish over time. Because of considerable uncertainty about those future operations, CBO has formulated two budget scenarios involving the deployment of U.S. forces to Iraq, Afghanistan, and elsewhere in support of the war on terrorism. (Many other outcomes—some costing more and some less—are also possible.) Under both scenarios, reductions in force levels in Iraq beginning in 2009 are partially offset by a temporary increase in forces deployed to Afghanistan. As a result, the number of deployed troops declines from an average of 210,000 in 2008 but, under the two scenarios, at different rates and to different sustained levels. The amount of spending for the support of indigenous security forces in Iraq and Afghanistan and for diplomatic operations and foreign aid is the same under both scenarios.

Under the first scenario, troop levels would be rapidly reduced over a two-year period; deployed forces decline to an average of roughly 180,000 in 2009 and 90,000 in 2010, until 30,000 military personnel remained overseas in support of the war on terrorism at the start of 2011. That number of deployed troops would be sustained through 2019, although not necessarily in Iraq and Afghanistan. Under such a scenario, discretionary outlays for 2009 would be about $24 billion higher than the amount in the baseline, but annual outlays would be lower beginning in 2012. In total, over the 2010–2019 period, discretionary outlays would be $281 billion less than the amount recorded in the current baseline.

Under the second scenario, the number of troops would decline more gradually over a four-year period, dropping to an average of about 190,000 in both 2009 and 2010, then to 150,000 in 2011, and falling steadily throughout 2012, until 75,000 remained overseas by 2013 and each year thereafter. Under such a scenario, discretionary outlays for 2009 would increase by $26 billion compared with the amount in the current baseline, but annual outlays would fall slightly below the amounts projected beginning in 2016. During the 2010–2019 period, total outlays for activities related to the war on terrorism would exceed the amount reflected in the baseline by about $165 billion.

Other Discretionary Spending. There are many possible alternative assumptions about the future growth of discretionary spending. For example, if appropriations (other than those for operations in Iraq and Afghanistan) were assumed to grow through 2019 at the same rate as nominal GDP instead of at the rate of inflation, total projected discretionary spending would be $1.5 trillion higher than the amount in the current baseline. In contrast, if lawmakers did not increase appropriations after 2009 to account for inflation, cumulative discretionary outlays would be $1.2 trillion lower. Under that latter scenario (sometimes referred to as a "freeze" in appropriations), total discretionary spending would fall from 8.0 percent of GDP in 2008 to 5.1 percent in 2019.

Revenues. The baseline assumes that the major provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003—such as the introduction of the 10 percent tax bracket, increases in the child tax credit, the repeal of the estate tax, and lower rates on capital gains and dividends—will expire as scheduled at the end of 2010. On balance, the tax provisions that are set to expire during the 10-year projection period reduce revenues; thus, under a scenario in which they were extended, projected revenues would be lower than the amounts indicated in the current baseline. For example, if all expiring tax provisions (except those related to the amount of the exemption for the AMT) were extended, total revenues over the 2010–2019 period would be about $3.0 trillion lower than in the projection in the current baseline.[19]

Another change in policy that could affect revenues involves the modification of the AMT, which many observers believe will not be maintained in its current

19. That estimate reflects the fact that the effect of lowering the amount of taxpayers' regular tax liabilities would be partially offset by an increase in the number of taxpayers subject to the AMT. The estimate does not include any macroeconomic effects—unlike CBO's baseline projections, which incorporate the effects that the tax provisions' expiration would have on the economy. However, any macroeconomic effects are likely to be small relative to GDP. In addition, when CBO's recent report on the budget and economic outlook went to press, the Joint Committee on Taxation's (JCT's) most recent estimates of the effects of extending expiring tax provisions were based on CBO's baseline projections from February 2008, updated for laws enacted through August 2008. Therefore, CBO has adjusted those estimates to take into account its updated economic projections and recent changes in law. JCT is currently updating its estimates to reflect CBO's new projections, and CBO will make those estimates available when they are completed.

form. Because the AMT's exemption amount and brackets are not indexed for inflation, the impact of the tax will grow in coming years as more taxpayers become subject to it. If the AMT was indexed for inflation after 2008 and no other changes were made to the tax code, federal revenues over the next 10 years would be about $0.6 trillion lower than the amount in the baseline.

Because the number of taxpayers who are subject to the AMT will depend on whether the tax provisions originally enacted in 2001 and 2003 remain in effect, the combination of indexing the AMT for inflation and extending the expiring provisions would reduce revenues by more than the sum of the effects of each policy enacted alone. The interactive effect would lower revenues by an additional $0.6 trillion between 2011 and 2019.

The Treatment of the Troubled Asset Relief Program in the Federal Budget

The TARP was created by the Emergency Economic Stabilization Act of 2008 in October 2008 to enable the Secretary of the Treasury to purchase or insure troubled assets. Under the legislation, the authority to enter into agreements to purchase such assets is set to expire on December 31, 2009, but can be extended until October 3, 2010, upon certification by the Secretary that the extension is necessary.

The purchase price of all assets outstanding at any one time cannot exceed $700 billion (though cumulative gross purchases could exceed $700 billion as previously purchased assets are sold). Currently, the Secretary has the authority to purchase $350 billion in assets; the remaining $350 billion will become available if the Administration requests it and the Congress does not take action to deny that request.

As of December 19 (when CBO finalized its baseline), the TARP had used $198 billion to purchase equity in 116 financial institutions (including $40 billion for AIG). Between December 19 and December 31, the Treasury purchased another $40 billion in equity from 100 more banks (including a second purchase from Citigroup) and disbursed $9 billion in loans to the automakers. The Treasury has also announced plans for the following additional actions:

- Purchase of $10 billion for equity in Merrill Lynch (upon completion of its acquisition by Bank of America);
- A guarantee of a pool of assets owned by Citigroup, at a cost of up to $5 billion;
- Credit protection against debtors that do not pay because of insolvency or protracted default as part of the Federal Reserve's Term Asset-Backed Securities Loan Facility, at a cost of up to $20 billion;
- Loans to General Motors and Chrysler of another $8.4 billion; and
- The purchase of $5 billion in equity from GMAC (a financial services company) and an agreement to lend up to an additional $1 billion to General Motors to help GMAC reorganize as a bank holding company.

The Treasury has indicated that it will use the remainder of the initial $350 billion for additional equity purchases in financial institutions.

The legislation that created the TARP requires that the federal budget display the costs of purchasing or insuring troubled assets using procedures similar to those specified in the Federal Credit Reform Act but adjusting for market risk (in a manner not reflected in that law). In particular, the federal budget should not record the gross cash disbursement for the purchase of a troubled asset (or cash receipt for its eventual sale) but instead should reflect an estimate of the government's net cost for the purchase. Broadly speaking, the net cost is the purchase cost minus the present value—calculated using an appropriate discount factor that reflects the riskiness of the asset—of any estimated future earnings from holding the asset and the proceeds from the eventual sale of the asset.

Following that directive, CBO has estimated the present value of the net costs of the TARP's activities, accounting for the specific actions taken before December 19. In its estimates, CBO assumed that the full $700 billion of available purchasing authority will eventually be used (by the end of calendar year 2009) and that future disbursements will have a subsidy rate similar to the average for the transactions that occurred until December 19 (about 25 percent). All told, CBO estimates that the subsidy costs related to the TARP's transactions will total more than $180 billion in 2009 and about $5 billion in 2010

(some transactions may not take place until the next fiscal year begins in October).[20]

The Treatment of Fannie Mae and Freddie Mac in the Federal Budget

On September 6, 2008, exercising authority provided under the Housing and Economic Recovery Act of 2008 (P.L. 110-289), the Director of the Federal Housing Finance Agency (FHFA) and the Secretary of the Treasury placed Fannie Mae and Freddie Mac into conservatorship and took an ownership interest in each company. The Treasury received ownership interest in the form of senior preferred stock in exchange for any future contributions necessary to keep the GSEs solvent. The support agreements between the Treasury and the GSEs include several forms of compensation for the Treasury—most notably, warrants that, if exercised, would represent an ownership stake of 79.9 percent of each enterprise.

Although the GSEs have had a unique legal status and a long history linking them closely to the federal government, they have been considered private firms owned by their shareholders. However, because of the extraordinary degree of management and financial control that the government has now exercised, CBO concludes that the entities should now be considered federal operations. Although the GSEs are not legally government agencies and their employees are not civil servants, CBO believes it is appropriate and useful to policymakers to account for and display the GSEs' financial transactions alongside all other federal activities in the budget.

That view is consistent with the principles expressed by the 1967 President's Commission on Budget Concepts, which asserted that "the federal budget should, as a general rule, be comprehensive of the full range of federal activities. Borderline agencies and transactions should be included in the budget unless there are exceptionally persuasive reasons for exclusion."[21] The commission suggested certain broad criteria to help make such determinations. For example, who owns an entity and selects the managers? Do the Congress and the President have control over an entity's program and budget, or are its policies set primarily in response to private owners and not to accomplish some broader public purpose? Clearly, Fannie Mae and Freddie Mac are currently controlled and operated by the federal government and heavily dependent on the government for their access to the credit markets.

CBO accounts for the GSEs' operations in the federal budget using the same procedure that it applies in valuing the Treasury's purchases under the TARP (that is, computing the present value of anticipated cash flows using an appropriate discount factor that recognizes the riskiness of those cash flows). On the basis of projections of the entities' assets and liabilities over the long term, including their operations on the budget would increase the federal deficit by nearly $240 billion in 2009 and by about $70 billion between 2010 and 2019.

In CBO's baseline, most of the cost recorded in 2009 stems from the existing assets and liabilities of the GSEs at the time of their takeover. CBO estimates that the value of the GSEs' mortgage loans and guaranteed assets falls short of their liabilities by about $200 billion (on a present-value basis); that amount is included in CBO's estimate of the deficit calculated for 2009. Nearly $40 billion in 2009 and smaller annual amounts thereafter represent the estimated annual subsidy costs (on a net-present-value basis) associated with the GSEs' new business after the takeover. The combined subsidy rate for both GSEs' credit activities is estimated to be about 2.5 percent in 2009 and to decline to about 0.3 percent after 2014. The decline in the subsidy rate reflects CBO's forecast that housing and mortgage markets will stabilize over that period.

CBO has long held that the federal government has subsidized the operation of Fannie Mae and Freddie Mac by providing what some have called an "implicit guarantee" of the GSEs' debt.[22] However, the federal government has never recognized the cost of the subsidy in its budget. The value of that guarantee (the existence of which has now been explicitly demonstrated by the Treasury) is a large component of the estimated cost of the GSEs' operations that CBO has included in its baseline projections.

Because CBO considers the GSEs' activities part of the federal budget, the anticipated cash infusions from the

20. The Treasury thus far has recorded its purchases of equity in financial institutions on a cash basis.

21. President's Commission on Budget Concepts, *Report of the President's Commission on Budget Concepts* (October 1967).

22. See Congressional Budget Office, *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac* (May 1996) and *Federal Subsidies and the Housing GSEs* (May 2001).

Table 8.

Changes in CBO's Baseline Projections of the Deficit Since September 2008

(Billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
Total Deficit as Projected in September 2008	**-438**	**-431**	**-325**	**-126**	**-147**	**-170**	**-162**	**-207**	**-174**	**-135**	**-1,466**	**-2,313**
Changes to Revenue Projections												
Legislative	-104	-6	-3	-3	-1	-2	*	1	8	4	-118	-108
Economic	-106	-204	-242	-243	-216	-191	-187	-198	-212	-226	-1,010	-2,024
Technical	-152	-138	-108	-80	-48	-32	-24	-18	-15	-15	-527	-631
Total Revenue Changes	**-362**	**-348**	**-353**	**-327**	**-265**	**-226**	**-211**	**-215**	**-219**	**-237**	**-1,655**	**-2,763**
Changes to Outlay Projections												
Legislative												
Mandatory outlays												
TARP	184	5	*	*	*	*	*	*	*	*	189	189
Unemployment compensation	9	0	0	0	0	0	0	0	0	0	9	9
Other	5	2	1	2	*	*	*	*	1	-1	10	10
Subtotal, mandatory	198	7	1	2	*	*	*	*	1	-1	208	208
Discretionary outlays												
Defense	-22	-61	-88	-99	-105	-108	-111	-114	-116	-117	-375	-940
Nondefense	*	-6	-9	-12	-13	-14	-14	-14	-14	-14	-39	-109
Subtotal, discretionary	-22	-67	-97	-111	-118	-121	-124	-128	-130	-132	-414	-1,049
Net interest outlays (Debt service)	3	8	10	12	6	-3	-10	-19	-28	-47	39	-67
Total, legislative	**179**	**-51**	**-85**	**-98**	**-112**	**-124**	**-134**	**-146**	**-158**	**-180**	**-167**	**-909**
Economic												
Mandatory outlays												
Social Security	1	-10	-20	-25	-28	-30	-32	-35	-38	-42	-83	-260
Other COLA programs	*	-3	-7	-7	-8	-8	-8	-8	-8	-8	-25	-66
SNAP	5	11	14	15	12	10	8	6	4	2	57	86
Unemployment compensation	12	21	13	8	3	*	-1	-1	-1	-1	57	54
Medicare	-1	-2	-5	-6	-7	-10	-13	-14	-15	-15	-22	-89
Medicaid	2	4	3	*	-3	-6	-8	-9	-11	-12	4	-42
Earned income credit	*	-1	-4	-3	-3	-3	-2	-2	-2	-2	-12	-24
Oil and gas receipts[a]	6	7	8	8	8	8	8	8	8	8	37	77
Student loans	-5	-8	-7	-4	-1	*	*	*	*	*	-26	-27
Other	1	1	1	*	*	-1	-1	-2	-2	-3	3	-6
Subtotal, mandatory	20	19	-4	-15	-27	-40	-49	-58	-67	-75	-7	-296
Discretionary outlays	*	-1	-8	-13	-16	-18	-20	-20	-21	-22	-39	-140
Net interest outlays												
Debt service	*	2	5	13	24	32	40	48	56	65	44	286
Rate effect/inflation	-44	-79	-104	-81	-43	-28	-20	-14	-10	-8	-351	-431
Subtotal, net interest	-44	-78	-99	-67	-19	5	20	34	46	57	-307	-145
Total, economic	**-24**	**-60**	**-111**	**-96**	**-62**	**-53**	**-48**	**-45**	**-41**	**-40**	**-353**	**-580**

Continued

Table 8. Continued

Changes in CBO's Baseline Projections of the Deficit Since September 2008

(Billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
Changes to Outlay Projections (Continued)												
Technical												
Mandatory outlays												
Fannie Mae/Freddie Mac	218	15	14	8	6	3	4	4	4	4	261	279
Deposit insurance	24	27	4	-19	-17	-10	-3	-2	*	-1	19	3
Social Security	1	3	6	8	10	11	12	12	12	12	28	86
Medicare	5	-6	-10	-4	-9	-6	-6	-9	-10	-12	-23	-67
Medicaid	-3	-3	-2	-4	-6	-8	-10	-13	-16	-19	-18	-86
Spectrum auction	-17	1	*	0	0	0	0	0	0	0	-17	-17
Other	-10	4	8	-2	3	5	6	7	6	7	3	35
Subtotal, mandatory	217	42	19	-12	-13	-5	2	-2	-4	-10	253	233
Discretionary outlays	4	-2	-3	*	1	1	1	1	1	1	*	4
Net interest outlays												
Debt service	*	3	10	22	34	39	42	45	48	50	70	293
Other	8	-8	-9	-5	-2	-3	-1	-4	-5	-4	-16	-33
Subtotal, net interest	8	-5	1	17	32	36	41	41	43	46	54	261
Total, technical	**230**	**35**	**17**	**5**	**19**	**32**	**43**	**40**	**40**	**37**	**306**	**498**
Total Outlay Changes	**385**	**-76**	**-179**	**-189**	**-155**	**-146**	**-139**	**-151**	**-159**	**-183**	**-214**	**-991**
Total Impact on the Deficit[b]	**-748**	**-272**	**-174**	**-138**	**-110**	**-80**	**-72**	**-65**	**-60**	**-54**	**-1,442**	**-1,772**
Total Deficit as Projected in January 2009	**-1,186**	**-703**	**-498**	**-264**	**-257**	**-250**	**-234**	**-272**	**-234**	**-188**	**-2,908**	**-4,085**
Memorandum:[b]												
Total Legislative Changes	-283	45	82	95	110	122	134	147	166	183	49	801
Total Economic Changes	-82	-144	-131	-148	-153	-138	-139	-153	-171	-185	-658	-1,444
Total Technical Changes	-382	-173	-125	-85	-67	-64	-67	-58	-55	-52	-833	-1,129

Source: Congressional Budget Office.

Note: TARP = Troubled Asset Relief Program; COLA = cost-of-living adjustment; SNAP = Supplemental Nutrition Assistance Program; * = between -$500 and $500 million.

a. Receipts from leases for resource development on the Outer Continental Shelf.

b. Negative numbers indicate an increase in the deficit.

Treasury are essentially intragovernmental transfers that have no net effect on the budget. CBO estimates that such transfers will total nearly $18 billion in 2009 ($13.4 billion has already been provided by the Treasury to Freddie Mac) and close to $80 billion between 2010 and 2015.

Changes in the Budget Outlook Since September 2008

Economic conditions and policy actions have generated substantial changes to CBO's baseline since the previous one was published in September 2008.[23] Overall, CBO's estimate of the baseline deficit for 2009 has risen by nearly $750 billion; for the 2009–2018 period, projected deficits are about $1.8 trillion higher than previously estimated (see Table 8). Economic and technical revisions boost the cumulative deficit by $2.6 trillion over the 10-year period, but changes related to legislation diminish that figure by about $800 billion.

Economic Changes. Revisions attributable to changes in CBO's economic forecast since September have led to an average increase in the projected deficit of almost $145 billion a year. In the current baseline, projected revenues have been decreased by an average of $200 billion a year and outlays by nearly $60 billion annually.

Reflecting both lower real growth and lower inflation anticipated in the new economic assumptions, CBO has lowered its projections of nominal GDP and the components of taxable income, most importantly wages, salaries, and corporate profits. Those downward revisions were most significant for 2009 through 2011, but lower prices and lower nominal income continue through the end of the projection period. In sum, those changes caused CBO to reduce its projection of revenues by $106 billion in 2009, $204 billion in 2010, and a total of $2.0 trillion over the 2009–2018 period.

A portion of the drop in projected revenues has been offset on the outlay side of the budget. Economic factors have reduced projected outlays by $580 billion between 2009 and 2018. In the current baseline, substantially lower inflation for the next few years reduces the anticipated cost-of-living adjustments for Social Security and other benefit programs. (CBO anticipates that the year-over-year change in consumer prices for the third quarter of 2009 will show a decline, which implies that next year's cost-of-living adjustment for Social Security and most other benefit programs will be zero.) In addition, lower inflation diminishes the projected growth of discretionary spending in the baseline. CBO has also reduced its projections of net interest payments by $431 billion over the 10-year period because of its expectation of lower inflation and lower interest rates. However, some of that decrease is offset by additional projected borrowing costs as a result of lower estimated revenues.

The changed economic outlook affects projected outlays in a number of other ways. CBO now anticipates that the unemployment rate for the next few years will be higher (by as much as 3 percentage points) than it forecast in September, which boosts the projected costs of unemployment compensation and nutrition assistance by $54 billion and $86 billion, respectively, over the 10-year period.[24] Also, the decline in projected oil and gas prices reduces estimated receipts from federal leases on the Outer Continental Shelf by $77 billion between 2009 and 2018.

Legislative Changes. Since September, the effects of legislation have added about $280 billion to CBO's projection of the deficit for 2009 but reduced its estimate of the cumulative deficit by about $800 billion over the 10-year period. The largest effects in 2009 stem from the Emergency Economic Stabilization Act of 2008 and its creation of the TARP. On a net-present-value basis adjusted for market risk, outlays for the program will total more than $180 billion in 2009 and $5 billion in 2010, CBO estimates. That legislation also included some tax provisions, most notably, extending relief from the AMT for a year. Altogether, legislative changes have caused CBO to reduce its estimate of revenues in 2009 by $104 billion and have had little impact on projected revenues thereafter.

The Unemployment Compensation Extension Act of 2008 (P.L. 110-449), enacted in November 2008, provides additional unemployment compensation to individuals who exhaust their regular benefits before March 31, 2009. CBO estimates the additional compensation will increase outlays by $9 billion in 2009.

23. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (September 2008).

24. Over 10 years, the effect of higher unemployment compensation on the budget is largely offset by higher revenues. States are assumed to replenish their depleted trust fund balances by increasing unemployment taxes, which are recorded as federal revenues.

The timing of appropriation actions can have a significant impact on CBO's baseline projections. Because baseline projections of discretionary spending are derived from the most recent appropriations, CBO based its September projections on appropriations for 2008, which included $186 billion for military and diplomatic operations in Iraq and Afghanistan and other activities in the war on terrorism. To date, less than $70 billion has been provided for 2009 for such activities; the effect of extending that smaller amount of enacted appropriations (as well as other differences in the amounts appropriated last year and this year) has reduced projected discretionary outlays from 2009 to 2018 by more than $1 trillion from the amount estimated in September.[25]

Technical Changes. Factors not directly attributable to changes in CBO's economic forecast or legislation—that is, technical changes—have increased projected deficits for 2009 through 2018 by $1.1 trillion from the amounts projected in September. About 55 percent of those changes have occurred on the revenue side of the budget.

Changes in factors affecting the amount of revenue yielded by a given amount of GDP and its income components have caused CBO to lower its projection of revenues by $152 billion for 2009, $138 billion for 2010, and by more than $600 billion for the 2009–2018 period. Those technical factors are largely related to the current economic environment but are not specifically addressed in the economic forecast.

The recent decline in the stock market is the most important cause of the reduction in projected revenues attributable to technical factors. That change has caused CBO to significantly lower its projections of realizations of capital gains by individuals and corporations, distributions received by individuals from their tax-deferred retirement accounts, and the amount of wealth subject to the estate tax. To some extent, those downward adjustments persist throughout the 10-year projection period to reflect a permanently lower amount of wealth. Technical factors that are not related to the current economic environment, such as updates to certain models to reflect new research and data, have caused a relatively small change to the revenue outlook in the near term and have caused changes that offset some of the downward adjustments in the later part of the projection period.

For 2009 through 2018, CBO has increased its projection of outlays by $498 billion to reflect technical changes. The largest contributor to that figure is the agency's decision to include the operations of Fannie Mae and Freddie Mac as part of the federal budget; subsidy costs for those entities have added $279 billion to the baseline over the 10-year period. (In its previous baseline, which was developed before the takeover of the two GSEs, CBO had included $25 billion for potential payments to keep them solvent.)

Net outlays for deposit insurance are now projected to be about $19 billion higher over the next five years than the amount estimated in September because of an expected increase in the number of failed banks, thrifts, and credit unions. The net increase over the 10-year period is much smaller ($3 billion) because the near-term costs should eventually be offset by proceeds from the sale of liquidated assets and higher premiums for deposit insurance.

Projections for Social Security, Medicare, and Medicaid include relatively small technical adjustments based on changes in expected caseloads and other new information. CBO has raised its projection of Social Security outlays over the 2009–2018 period by $86 billion (or by 1 percent), nearly all of which is attributable to an increase in the number of beneficiaries participating in the Disability Insurance program; CBO has reduced its projections by similar amounts for Medicare (primarily because of lower-than-expected outlays in 2008 for prescription drugs under Part D of the program and for hospital inpatient and post-acute services under Part A) and Medicaid (largely because of lower-than-expected outlays in 2008).

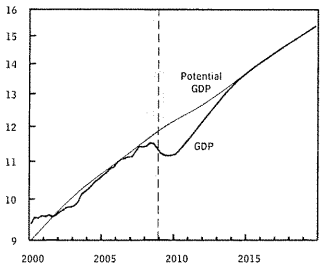
CBO's current baseline includes receipts (negative outlays) of $17 billion in 2009 from auctions held in 2008 of licenses for the commercial use of radio frequencies that are currently used for television broadcasts. Those receipts were originally expected to be recorded last year but were delayed pending the issuance of the licenses.

Debt service on other technical changes and small adjustments to certain assumptions about the Treasury's borrowing have caused CBO to raise projected outlays for net interest between 2009 and 2018 by $261 billion.

25. If regular or supplemental appropriations are enacted in place of or in addition to the current continuing resolution, subsequent baseline projections will incorporate their effects.

Figure 12.

GDP and CBO's Estimate of Potential GDP



Source: Congressional Budget Office.

Note: GDP = gross domestic product.

The Long-Term Outlook

High deficits in the near term may be inevitable in the face of the financial crisis and severe economic weakness. However, once the nation gets past this downturn, it will still face significant fiscal challenges posed by rising health care costs and the aging of the population. Continued large deficits and the resulting increases in federal debt over time would probably constrain long-term economic growth by reducing national savings and investment, which in turn would cause productivity and wage growth to gradually slow.

The rate of growth of spending on health care is the single greatest threat to budget balance over the long run, and such spending will have to be controlled in order for the fiscal situation to be sustainable in future decades.[26] Together, outlays for Medicare and Medicaid (not including offsetting receipts) currently account for about 5 percent of GDP. Spending for those programs is expected to rise at a rapid pace over the next 10 years, outstripping the growth of GDP. By 2019, spending for those programs combined is projected to total about 6.3 percent of GDP. By 2050, it could reach 12 percent. Without changes to federal fiscal policy, those rising costs would drive the amount of debt held by the public significantly higher as a percentage of GDP than it is today.

Principles for Fiscal Stimulus

In the absence of any changes in policy, CBO projects that the economy will produce about $1 trillion less output per year than its estimated potential in each of 2009 and 2010 and significantly less than its potential in 2011 and 2012 as well (see Figure 12). The unemployment rate is forecast to rise above 9 percent by early next year.

Many economists believe that a stimulative fiscal policy (that is, an increase in spending or reduction in taxes designed to foster faster economic growth in the short run) is desirable under the current economic conditions. Recessions are characterized by a self-reinforcing cycle—firms cut production and employment because of a shock, such as a falloff in sales—and the resulting reduction in income and confidence among workers leads them to reduce purchases, and sales fall even further. Fiscal stimulus may dampen that cycle by increasing spending by households, businesses, or governments. Some degree of fiscal stimulus is automatic in a recession, as lower incomes mean lower taxes and increased spending for unemployment insurance benefits and nutrition assistance (as described on page 4). Additional stimulus can be provided through tax cuts or transfer payments (such as expanded unemployment insurance) or by direct purchases of goods and services by the federal government or state and local governments.

Another significant source of economic stimulus is monetary policy. The Federal Reserve has provided substantial monetary stimulus, but with the financial sector in such turmoil and a broad lack of confidence in the economy, easing the availability of credit may not be enough to both stabilize the financial system and provide a significant boost to economic activity.

The uncertainty of the economic outlook suggests another possible justification for a stimulative fiscal policy. The problems in financial markets could be worse

26. In December 2008, CBO released two volumes that focus on health care issues: *Key Issues in Analyzing Major Health Insurance Proposals* and *Budget Options, Volume 1: Health Care*. Those reports, which build upon CBO's previous analytical work on health insurance and other issues in financing health care, are intended to assist the Congress as it contemplates possible changes—both large and small—to federal health programs and the nation's health insurance and health care systems.

than CBO's forecast anticipates, and, as a result, the economy could experience a more protracted period of recession and subpar growth than indicated by that forecast. An effective fiscal stimulus could serve as an insurance policy against that risk.

In general, fiscal stimulus policies are most effective if they are timely, cost-effective, and consistent with long-run budget objectives:

- The **timeliness** of fiscal stimulus is critical. Ideally, the economic effects of the stimulus should match the period of economic weakness.
  - The timing of the economic effects of fiscal stimulus will depend both on when the policies are enacted and when the policies affect spending by consumers, firms, and governments. When a recession is already underway and aggregate demand is declining, the most effective stimulus policy would be one that was enacted rapidly and that would affect spending quickly; otherwise, the policy would risk postponing stimulative effects until the economy was already recovering.
  - A fiscal stimulus that continues after the period of economic weakness runs the risk of causing higher inflation and interest rates. (That period, however, could encompass some time after the recession when the economy may still be producing well below its potential output.) But a fiscal stimulus that ends before the economy has started to regain its footing runs the risk of exacerbating that weakness when the stimulus ends.
- A desirable stimulus policy should increase aggregate demand as much as possible for a given budgetary cost; that is, it should be **cost-effective**.
  - The most cost-effective policies would provide additional resources to the households, firms, or governments most likely to use them for additional purchases of goods and services. Different policies that might be included in a stimulus package differ widely in this respect.
  - Efforts to push out spending too quickly may result in a less well considered or less efficient use of taxpayers' money.
  - Policies that accelerate costs that the government will ultimately incur in any event (for example, delaying tax liabilities or accelerating planned spending) would have little net cost but might provide economic benefits.
- It is desirable that efforts at short-term fiscal stimulus **not significantly exacerbate the nation's long-run fiscal imbalance**.
  - Policies that may be desirable and beneficial in the short term may or may not be beneficial in addressing the nation's long-term fiscal challenges.
  - Fiscal stimulus adds to the federal debt, already a concern in the light of growing demands on the federal budget from the aging of the baby boomers and, especially, from the rising cost of health care. For every $100 billion in additional federal debt, future taxpayers will probably have to pay about $5 billion a year in interest costs.
  - Large and persistent federal deficits tend to slow economic growth in the long term. They reduce the national saving rate and capital accumulation and thereby slow the growth of the economy's capacity to produce.
  - Spending and tax policies that enhance future productive capacity offset some of the potential adverse long-run effects of the additional debt associated with short-term stimulus.
  - A large increase in debt poses risks. At some point investors here and abroad might decide that they have enough Treasury securities in their portfolios. From then on, they might continue to purchase those securities only if offered higher interest rates. The accumulation of Treasury debt risks the possibility that, in some future financial crisis, investors might not "flee to quality" by buying U.S. Treasury securities but would instead purchase some other assets, leaving the government with less flexibility or much higher costs for dealing with such a situation.
  - Finally, spending or tax changes intended to be temporary may be difficult to reverse later.

The size of the effects of fiscal stimulus on the economy is quite uncertain and subject to considerable debate among economists. Some argue, for example, that last summer's fiscal stimulus had little effect; others argue that it had a more significant effect. But there is generally little dispute that spending increases or tax cuts would increase GDP in the short run under the current circumstances.

Appendix A: The Government's Actions in Support of the Housing and Financial Markets

The turmoil in the housing and financial markets has generated a series of policy responses from various parts of the government—the Federal Reserve, the Department of the Treasury, and other agencies. Some responses have stemmed from existing authority, others from recent legislation. The tables in this appendix briefly describe the major policy actions taken by each entity.

The Federal Reserve

Many of the actions taken by the Federal Reserve derive from section 13(3) of the Federal Reserve Act. That section gives the central bank broad authorities in "unusual and exigent circumstances" to extend credit directly to an "individual, partnership, or corporation." That authority has been used in a variety of new and innovative programs in recent months to provide more than $1 trillion in financial support to banks, corporations, money market funds, and other institutions (see Table A-1).

Activities of the Federal Reserve are not directly recorded in the federal budget. Rather, each year its net earnings—generated by interest on its holdings of securities; income from foreign currency holdings; fees received for services provided to institutions that accept monetary deposits from consumers (such as check clearing, funds transfers, and automated clearinghouse operations); and interest on loans to such institutions—are remitted to the Treasury and recorded in the budget as revenues. That income is typically in the range of $20 billion to $30 billion a year.[1]

Thus, recent actions by the Federal Reserve to address the turmoil in the markets may affect federal revenues through their impact on the amount of earnings that the Federal Reserve remits to the Treasury. Those earnings would be diminished by any losses incurred if creditors were unable to repay loans or if the assets acquired proved to be worth less than the cost to acquire them. Although the Federal Reserve loaned more than $1 trillion in 2008 through its various programs, it does not intend to subsidize borrowers by paying more for assets than they are worth, and it has structured the transactions to minimize the chance of losses to its portfolio. Losses are possible, however; for example, the Federal Reserve has already written down—by about $2 billion—the value of the assets it acquired in the takeover of Bear Stearns.

The Department of the Treasury

Most of the actions taken by the Treasury were authorized by recent legislation. At the end of July, the Housing and Economic Recovery Act of 2008 (Public Law 110-289) authorized actions to provide support for the housing market. Among the provisions of that act was the authority for the Director of the Federal Housing Finance Agency (FHFA) and the Secretary of the Treasury to place Fannie Mae and Freddie Mac into conservatorship and take ownership interest in each company.[2]

In early October, the Emergency Economic Stabilization Act of 2008 (Division A of P.L. 110-343) established the Troubled Asset Relief Program (TARP), authorizing the Treasury to purchase $700 billion in assets to alleviate the crisis in credit markets (see Table A-2). The first $350 billion is now available for obligation; the second $350 billion will become available if the Administration requests it and the Congress does not take action to deny that request.

As of December 31, the program had disbursed $238 billion to banks and other institutions in exchange for shares

1. The Federal Reserve is now paying interest on required reserves and excess balances held on behalf of financial institutions. The interest paid on those deposits is linked to the federal funds rate; the Congressional Budget Office estimates that the Federal Reserve will incur interest costs of less than $5 billion in 2009. Authorization to pay interest on such reserves came from the Emergency Economic Stabilization Act of 2008, which advanced the effective date of a provision of the Financial Services Regulatory Relief Act of 2006 that was slated to take effect in 2011.

2. Conservatorship is the legal process in which an entity is appointed to establish control and oversight of a company to put it in a sound and solvent condition.

of preferred stock and warrants. (Preferred stock refers to shares of equity that provide a specific dividend to be paid before any dividends are paid to common stockholders and that take precedence over common stock in the event of a liquidation; a warrant is a security that entitles the holder to buy stock of the company that issued it at a specified price.) The program will also finance up to $17.4 billion in loans for General Motors and Chrysler (the automakers have received $9 billion already) and $6 billion in assistance related to GMAC, a financial services company.

Funds have also been pledged for additional capital purchases. Furthermore, the TARP is responsible for $20 billion in credit protection (protection against debtors that do not pay because of insolvency or protracted default) for the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) and $5 billion in credit protection for assets held by Citigroup. In total, the funds already disbursed and those committed but not yet disbursed are likely to consume all of the first $350 billion available under the TARP.

Spending for some programs conducted by the Treasury will be recorded in the budget on a discounted present-value basis rather than on a cash basis.[3] For those programs, the budget records the cost of the subsidy provided—that is the cost resulting from interest subsidies, potential defaults on that lending, and other factors.

3. The Administration is accounting for capital purchases made under the TARP on a cash basis rather than the present-value basis that was specified in the Emergency Economic Stabilization Act of 2008. That treatment will show more outlays than under CBO's treatment for the TARP this year and then cash receipts in future years.

Other Agencies

A few other agencies have also taken actions in response to the turmoil in the markets, either through existing authority or on the basis of recent legislation. The Federal Deposit Insurance Corporation (FDIC) temporarily raised the limit on insurance coverage—from $100,000 to $250,000—as a result of a provision in the Emergency Economic Stabilization Act of 2008. Through existing authority to reduce systemic risks to the economy, the FDIC established a program to enhance liquidity by guaranteeing debt issued by financial institutions as well as certain deposits in checking accounts and other non-interest-bearing accounts; it will also provide assistance to Citigroup using that existing authority (see Table A-3).

The Department of Housing and Urban Development (HUD) has established several programs in an attempt to reduce foreclosures and address other issues in the housing market. Many of those programs were created by the Housing and Economic Recovery Act of 2008, but HUD has also used existing authority to create the FHA Secure program.

FHFA, under authority granted by the Housing and Economic Recovery Act of 2008, placed Fannie Mae and Freddie Mac under conservatorship. In addition, FHFA is planning to use its existing authority to create a program to streamline the loan modification process.

Financial turmoil has also affected credit unions. As a result, the National Credit Union Administration has created programs (under existing authority) to ensure the liquidity of its member institutions.

Table A-1.

Actions Taken by the Federal Reserve in Support of the Housing and Financial Markets as of December 31, 2008

(Billions of dollars)

Action	Funding: Committed to Date	Funding: Potential[a]	Description
Reductions in Interest Rates	n.a.	n.a.	The target for the federal funds rate (the interest banks charge on loans to other banks) was reduced 10 times between September 2007 and December 2008, falling from 5.25 percent to between zero and 0.25 percent.
Loans to Financial Institutions			
Primary and Secondary Credit Programs	94	Unknown	Through the primary and secondary credit programs, the Federal Reserve disburses short-term loans to banks and other institutions that are legally allowed to accept monetary deposits from consumers. The term of the loan may be as long as 90 days.
Term Auction Facility	450	600	The Term Auction Facility (TAF) allows banks and other financial institutions to pledge collateral in exchange for a loan from the Federal Reserve. The interest rate on the loan is determined by auction; such auctions are conducted biweekly for loans with a maturity of either 28 or 84 days. The maximum size of each auction is $150 billion, although accepted bids for most recent auctions have been considerably smaller.
Takeover of Bear Stearns Backed assets to facilitate takeover of Bear Stearns by JP Morgan Chase	29	29	The Federal Reserve created Maiden Lane I, a limited liability company (LLC), to acquire certain assets of Bear Stearns at a cost of $29 billion. (An LLC offers protection from personal liability for business debts, just like a corporation. The profits and losses of the business pass through to its owners, as they would if the business was a partnership or sole proprietorship.) The LLC will manage those assets to maximize the likelihood that the investment is repaid and to minimize disruption to financial markets. The current value of the portfolio on the Federal Reserve's balance sheet is $27 billion.

Continued

Table A-1. Continued

Actions Taken by the Federal Reserve in Support of the Economy and Financial Markets as of December 31, 2008

(Billions of dollars)

Action	Funding: Committed to Date	Funding: Potential[a]	Description
Support for AIG Acquired control of nearly 80 percent of the insurance company	83	113	The Federal Reserve agreed to loan AIG $60 billion and acquired control of nearly 80 percent of the company. In addition, the Federal Reserve Bank of New York bought $19.5 billion of residential mortgage-backed securities from AIG's portfolio through an LLC and another $24.5 billion of collateralized debt obligations (CDOs) on which AIG wrote contracts for credit default swaps through another LLC. (CDOs are complex financial instruments that repackage assets such as mortgage bonds, loans for leveraged buyouts, and other debt—including other CDOs—into new securities. A credit default swap is a type of insurance arrangement in which the buyer pays a premium at periodic intervals in exchange for a contingent payment in the event that a third party defaults. The size of the premium paid relative to the contingent payment generally increases with the likelihood of default.)
Support for Short-Term Corporate Borrowing Commercial Paper Funding Facility	334	1,800	The Commercial Paper Funding Facility (CPFF) finances the purchase of commercial paper (securities sold by large banks and corporations to obtain funding to meet short-term borrowing needs, such as payroll) directly from eligible issuers. Securities purchased under this program may be backed by assets or unsecured; they must be highly rated, denominated in U.S. dollars, and have a maturity of three months. The program is in effect through April 30, 2009.
Support for Money Market Mutual Funds			
Money Market Investor Funding Facility	0	540	The Money Market Investor Funding Facility (MMIFF) is designed to restore liquidity to money markets by purchasing certificates of deposit and commercial paper from money market mutual funds. The authority to purchase assets is in effect through April 30, 2009.
Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility	24	Unknown	The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) provides funding to U.S. depository institutions and bank holding companies to finance their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds under certain conditions. The program is intended to assist money market funds that hold such paper in meeting demands for redemptions by investors and to foster liquidity in the ABCP market specifically and money markets generally. The program is in effect through April 30, 2009.

Continued

Table A-1. Continued

Actions Taken by the Federal Reserve in Support of the Housing and Financial Markets as of December 31, 2008

(Billions of dollars)

Action	Funding: Committed to Date	Funding: Potential[a]	Description
Support for Primary Dealers			
Term Securities Lending Facility and TSLF Options Program	172	200	The Term Securities Lending Facility (TSLF) offers to lend Treasury securities held by the Federal Reserve for a one-month term in exchange for other types of securities held by the 17 financial institutions, known as primary dealers, that trade directly with the Federal Reserve. The TSLF Options Program (TOP) offers options on short-term TSLF loans that will be made on a future date. (An option is a contract written by a seller that conveys to the buyer the right—but not the obligation—to buy or sell a particular asset.)
Primary Dealer Credit Facility	37	Unknown	The Primary Dealer Credit Facility (PDCF) provides overnight loans in exchange for eligible collateral to financial institutions that trade directly with the Federal Reserve. The program is in effect through April 30, 2009.
Support for the Mortgage Market			
Purchases of the debt of the housing-related government-sponsored enterprises	15	100	The Federal Reserve will purchase up to $100 billion in debt issued by three government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—through competitive auctions over the next several quarters.
Purchases of mortgage-backed securities	0	500	Over the next several quarters, the Federal Reserve will purchase up to $500 billion in mortgage-backed securities (MBSs) issued by GSEs and the Government National Mortgage Association (Ginnie Mae). The MBS purchases are expected to begin in early January.
Support for Consumer and Small Business Lending			
Term Asset-Backed Securities Loan Facility	0	200	Through the Term Asset-Backed Securities Loan Facility (TALF), the Federal Reserve Bank of New York will lend up to $200 billion to holders of certain AAA-rated asset-backed securities (consumer and small business loans), and the Troubled Asset Relief Program will provide $20 billion of credit protection (protection against debtors that do not pay because of insolvency or protracted default) for those loans. The TALF is expected to begin lending in February 2009; the authority expires on December 31, 2009.

Continued

Table 3-1. Continued

Actions Taken by the Federal Reserve in Support of the Housing and Financial Markets as of December 31, 2008

(Billions of dollars)

Action	Funding: Committed to Date	Funding: Potential[a]	Description
Assistance to Citigroup	0	234	The Federal Reserve will absorb 90 percent of any losses resulting from the federal government's guarantee of a pool of Citigroup's assets after payouts have been made by Citigroup, the Troubled Asset Relief Program, and the Federal Deposit Insurance Corporation.
Currency Swaps	At least 500	Unlimited	In response to strong demand for dollars from abroad, the Federal Reserve has contracted with 14 foreign central banks to make U.S. dollars available temporarily. After a specified period of time, the original amounts of dollars will be returned in exchange for the foreign currency.

Source: Congressional Budget Office based on information from the Federal Reserve.

Note: n.a. = not applicable.

a. "Potential funding" refers to the size of the market or the maximum amount of lending under the program.

Table A-2.

Actions Taken by the Treasury in Support of the Housing and Financial Markets as of December 31, 2008

(Billions of dollars)

Action	Disbursements To Date	Disbursements Potential[a]	Subsidy[b] (Credit basis)	Description
Troubled Asset Relief Program	247	700	64	The Emergency Economic Stabilization Act of 2008 (Division A of PL. 110-343) granted authority to the Treasury to purchase $700 billion in assets through a new program, the Troubled Asset Relief Program (TARP). The second $350 billion will become available if the Administration requests it and the Congress does not take action to deny that request. As of December 31, the program had disbursed $247 billion. The subsidy cost estimated by the Congressional Budget Office—about $64 billion to date—is computed using the modified credit reform procedure (that is, accounting for market risk) specified in PL. 110-343.
Housing-Related Tax Provisions	0	12	n.a.	The Housing and Economic Recovery Act of 2008 (PL. 110-289) authorized a refundable tax credit for first-time home buyers (to be repaid, without interest, over a 15-year period) and contained other housing-related tax provisions.
Purchases of Obligations and Securities Issued by Fannie Mae and Freddie Mac	71	Unlimited	-1	The Housing and Economic Recovery Act of 2008 authorized the Department of the Treasury to buy obligations and securities issued by Fannie Mae and Freddie Mac. About $71 billion of residential mortgage-backed securities (securities whose value is derived from an underlying pool of mortgages) had been purchased as of December 31, 2008. Authority to make such market purchases expires on December 31, 2009. The subsidy cost recorded in the budget is computed using standard credit reform procedures.

Continued

Table 2-2. Continued

Actions Taken by the Treasury in Support of the Housing and Financial Markets as of December 31, 2008

(Billions of dollars)

Action	Disbursements To Date	Disbursements Potential[a]	Subsidy[b] (Credit basis)	Description
Conservatorship for Fannie Mae and Freddie Mac	14	200	n.a.	The Treasury received senior preferred equity shares and warrants in exchange for any future contributions necessary to keep the two entities solvent. (Preferred equity shares provide a specific dividend to be paid before any dividends are paid to common stockholders and take precedence over common stock in the event of a liquidation; a warrant is a security that entitles the holder to buy stock of the company that issued it at a specified price.)
Temporary Guarantee Program for Money Market Funds	Unknown	3,000	n.a.	The Treasury will guarantee investors' shares as of September 19, 2008. The guarantee is in effect through April 30, 2009, but can be extended through September 18, 2009. Participating funds pay a fee of 1.5 or 2.2 basis points times the number of shares outstanding. (A basis point is one-hundredth of a percentage point.)
Supplemental Financing Program	259	Unlimited	n.a.	The Treasury is borrowing from the public to assist the Federal Reserve.

Source: Congressional Budget Office based on information from the Department of the Treasury.

Note: n.a. = not applicable.

a. "Potential disbursements" refers to the maximum amount of spending under the program or the maximum amount of outstanding assets available for guarantee.

b. "Subsidy," broadly speaking, refers to the purchase cost minus the present value of any estimated future earnings from holding those assets and the proceeds from the eventual sale of them.

Table A-3.

Actions Taken by Other Agencies in Support of the Housing and Financial Markets as of December 31, 2008

(Billions of dollars)

Action	Disbursements: To Date	Disbursements: Potential[a]	Description
Federal Deposit Insurance Corporation			
Temporarily Raised the Basic Limit on Insurance Coverage from $100,000 to $250,000 per Depositor	n.a.	700	The Emergency Economic Stabilization Act of 2008 (Division A of P.L. 110-343) temporarily raised the limit on deposit insurance through December 31, 2009. That action is estimated to increase the amount of insured deposits by about $700 billion, or 15 percent.
Temporary Liquidity Guarantee Program	n.a.	1,450	The Temporary Liquidity Guarantee Program has two components. The first—the debt guarantee program—aims to enable participating institutions to borrow and lend money more readily. It fully protects certain newly issued senior unsecured debt (securities that are not backed by collateral and have priority over all other debt in ranking for payment in the event of default) with a maturity of more than 30 days, including promissory notes, commercial paper (securities sold by large banks and corporations to meet short-term needs, such as payroll), and interbank funding. The guarantee applies to debt that is issued by June 30, 2009, and matures no later than June 30, 2012. Participating institutions pay fees based on the maturity of the debt. To date, the Federal Deposit Insurance Corporation (FDIC) has guaranteed $258 billion of new debt; potential guarantees could total $1 trillion. The second component provides full guarantees for certain checking and other non-interest-bearing accounts through December 31, 2009. Participating institutions also pay fees for this guarantee, which could total $450 billion.
Assistance to Citigroup	0	10	The FDIC may absorb up to $10 billion in losses resulting from the federal government's guarantee of a pool of Citigroup's assets after payouts have been made by Citigroup and the Troubled Asset Relief Program. As a fee for the guarantee, the FDIC will receive $3 billion in preferred stock (shares of equity that provide a specific dividend to be paid before any dividends are paid to common stockholders and that take precedence over common stock in the event of a liquidation).
Department of Housing and Urban Development			
Redevelopment of Abandoned and Foreclosed Homes	0	4	The Housing and Economic Recovery Act of 2008 (P.L. 110-289) provided $4 billion in funding to state and local governments to purchase and rehabilitate foreclosed and abandoned homes.
HOPE for Homeowners Program	0	1	The HOPE for Homeowners program permits home mortgages to be refinanced through private lenders with a guarantee from the Federal Housing Administration. The new loans must have a loan-to-value ratio that is no greater than 90 percent of the property's appraised value.

Continued

Table A-3. Continued

Actions Taken by Other Agencies in Support of the Housing and Financial Markets as of December 31, 2008

(Billions of dollars)

Action	Disbursements: To Date	Disbursements: Potential[a]	Description
Department of Housing and Urban Development (Continued)			
FHA Secure	n.a.	1	FHA Secure was a temporary initiative to permit lenders to refinance non-FHA (Federal Housing Administration) adjustable-rate mortgages. The program has made about 4,000 loans since fall 2007 and expired on December 31, 2008.
Federal Housing Finance Agency			
Conservatorship for Fannie Mae and Freddie Mac	n.a.	n.a.	The Federal Housing Finance Agency and the Treasury took control of these two government-sponsored enterprises (GSEs) on September 6, 2008. Under the current circumstances, the Congressional Budget Office (CBO) views Fannie Mae and Freddie Mac as governmental entities.
Streamlined Modification Program	Unknown	Unknown	The Streamlined Modification Program is intended to avoid foreclosures by creating a fast-track method for reducing monthly payments on mortgages. The program will restrict payments to 38 percent of a household's gross monthly income by reducing the interest rate, extending the life of the loan, or deferring principal. That policy applies to loans held by Fannie Mae and Freddie Mac and was launched on December 15, 2008.
National Credit Union Administration			
Credit Union Homeowners Affordability Relief Program and Credit Union System Investment Program	0	41	These two loan programs are operated through the National Credit Union Administration's Central Liquidity Facility and are financed by borrowing from the Federal Financing Bank. The Credit Union Homeowners Affordability Relief Program (CU HARP) will provide subsidized funding intended to help credit unions modify mortgages. The Credit Union System Investment Program (CU SIP) seeks to facilitate lending by shoring up corporate credit unions (which primarily provide financial resources and services to other credit unions).
Temporary Corporate Credit Union Liquidity Guarantee Program	1	Unknown	The Temporary Corporate Credit Union Liquidity Guarantee Program guarantees certain unsecured debt of participating corporate credit unions that was or will be issued between October 16, 2008, and June 30, 2009. Such debt must mature by June 30, 2012. Participating institutions pay annualized fees for the guarantees.

Source: Congressional Budget Office based on information from the Federal Deposit Insurance Corporation, the Department of Housing and Urban Development, the Federal Housing Finance Agency, and the National Credit Union Administration.

Note: n.a. = not applicable.

a. "Potential disbursements" refers to the maximum amount of spending under the program or the maximum amount of outstanding assets available for guarantee.

Appendix B: CBO's Economic Projections for 2009 to 2019

The tables in this appendix expand on the information in the body of the report by showing the Congressional Budget Office's (CBO's) year-by-year economic projections for 2009 to 2019 (by calendar year in Table B-1 and by fiscal year in Table B-2). CBO does not forecast cyclical fluctuations in its projections for years after 2010. Instead, the projected values shown in the tables for 2011 to 2019 reflect CBO's assessment of average values for that period. That assessment takes into account economic and demographic trends but does not attempt to forecast the frequency and size of ups and downs in the business cycle.

Table B-1.

CBO's Year-by-Year Forecast and Projections for Calendar Years 2009 to 2019

	Estimated	Forecast		Projected								
	2008[a]	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Nominal GDP (Billions of dollars)	14,304	14,241	14,591	15,347	16,293	17,280	18,211	19,077	19,909	20,749	21,617	22,500
Nominal GDP (Percentage change)	3.6	-0.4	2.5	5.2	6.2	6.1	5.4	4.8	4.4	4.2	4.2	4.1
Real GDP (Percentage change)	1.2	-2.2	1.5	4.2	4.4	4.1	3.5	2.8	2.5	2.3	2.2	2.2
GDP Price Index (Percentage change)	2.4	1.8	0.9	1.0	1.7	1.8	1.8	1.9	1.9	1.9	1.9	1.9
PCE Price Index[b] (Percentage change)	3.3	0.6	1.3	1.3	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Core PCE Price Index[c] (Percentage change)	2.2	1.5	0.9	1.2	1.7	1.9	1.9	1.9	1.9	1.9	1.9	2.0
Consumer Price Index[d] (Percentage change)	4.1	0.1	1.7	1.8	2.0	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Core Consumer Price Index[e] (Percentage change)	2.3	1.6	1.3	1.6	2.0	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index[f] (Percentage change)	3.0	2.7	2.7	3.0	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	5.7	8.3	9.0	8.0	6.8	5.8	5.1	4.9	4.8	4.8	4.8	4.8
Three-Month Treasury Bill Rate (Percent)	1.4	0.2	0.6	2.1	4.0	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	3.7	3.0	3.2	3.6	4.7	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Tax Bases (Billions of dollars)												
Economic profits	1,533	1,384	1,413	1,559	1,715	1,856	1,952	2,001	2,041	2,084	2,139	2,187
Wages and salaries	6,548	6,551	6,740	7,011	7,472	7,920	8,344	8,742	9,127	9,517	9,916	10,324
Tax Bases (Percentage of GDP)												
Economic profits	10.7	9.7	9.7	10.2	10.5	10.7	10.7	10.5	10.3	10.0	9.9	9.7
Wages and salaries	45.8	46.0	46.2	45.7	45.9	45.8	45.8	45.8	45.8	45.9	45.9	45.9

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

Note: GDP = gross domestic product; percentage changes are measured from one year to the next.

a. Values as of December 10, 2008.

b. The personal consumption expenditure chained price index.

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

d. The consumer price index for all urban consumers.

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

f. The employment cost index for wages and salaries of workers in private industry.

Table B-2.

CBO's Year-by-Year Forecast and Projections for Fiscal Years 2009 to 2019

	Actual	Forecast		Projected								
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Nominal GDP (Billions of dollars)	14,224	14,257	14,452	15,137	16,048	17,035	17,986	18,864	19,703	20,537	21,397	22,278
Nominal GDP (Percentage change)	4.3	0.2	1.4	4.7	6.0	6.1	5.6	4.9	4.4	4.2	4.2	4.1
Real GDP (Percentage change)	1.9	-1.9	0.4	3.8	4.4	4.2	3.7	3.0	2.5	2.3	2.2	2.2
GDP Price Index (Percentage change)	2.4	2.1	1.0	0.9	1.6	1.9	1.8	1.9	1.9	1.9	1.9	1.9
PCE Price Index[a] (Percentage change)	3.7	0.7	1.4	1.2	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Core PCE Price Index[b] (Percentage change)	2.3	1.7	1.0	1.1	1.6	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Consumer Price Index[c] (Percentage change)	4.4	0.5	1.4	1.8	1.9	2.2	2.3	2.2	2.2	2.2	2.2	2.2
Core Consumer Price Index[d] (Percentage change)	2.4	1.8	1.4	1.5	1.9	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index[e] (Percentage change)	3.1	2.7	2.6	2.9	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	5.3	7.7	9.1	8.3	7.1	6.0	5.3	4.9	4.8	4.8	4.8	4.8
Three-Month Treasury Bill Rate (Percent)	2.1	0.2	0.4	1.6	3.6	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	3.9	3.1	3.1	3.5	4.4	5.3	5.4	5.4	5.4	5.4	5.4	5.4
Tax Bases (Billions of dollars)												
Economic profits	1,564	1,413	1,390	1,521	1,677	1,823	1,933	1,991	2,032	2,071	2,125	2,176
Wages and salaries	6,522	6,549	6,649	6,950	7,360	7,808	8,241	8,644	9,031	9,419	9,815	10,221
Tax Bases (Percentage of GDP)												
Economic profits	11.0	9.9	9.6	10.0	10.4	10.7	10.7	10.6	10.3	10.1	9.9	9.8
Wages and salaries	45.8	45.9	46.0	45.9	45.9	45.8	45.8	45.8	45.8	45.9	45.9	45.9

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

Note: GDP = gross domestic product; percentage changes are measured from one year to the next.

a. The personal consumption expenditure chained price index.

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

c. The consumer price index for all urban consumers.

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

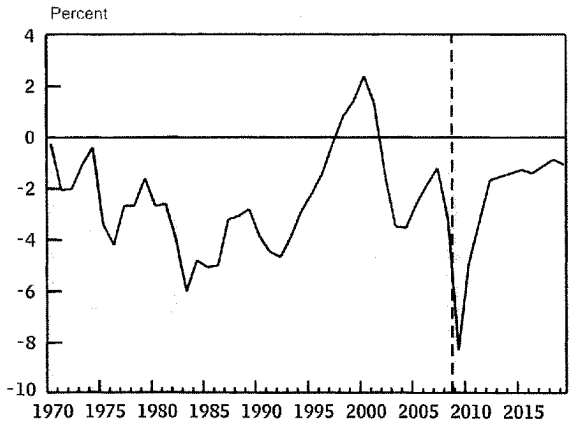
e. The employment cost index for wages and salaries of workers in private industry.

Congressional Budget Office

The Budget and Economic Outlook: Fiscal Years 2009 to 2019

January 8, 2009

The Total Deficit or Surplus as a Share of GDP, 1970 to 2019



CBO's Baseline Budget Projections

	Actual 2007	Actual 2008	2009	2010
		In Billions of Dollars		
Revenues	2,568	2,524	2,357	2,533
Outlays	2,729	2,978	3,543	3,236
Deficit	**-161**	**-455**	**-1,186**	**-703**
Debt Held by the Public	5,035	5,803	7,193	7,829
Memorandum:				
Gross Domestic Product	13,642	14,224	14,257	14,452
		As a Percentage of GDP		
Revenues	18.8	17.7	16.5	17.5
Outlays	20.0	20.9	24.9	22.4
Deficit	**-1.2**	**-3.2**	**-8.3**	**-4.9**
Debt Held by the Public	36.9	40.8	50.5	54.2

3

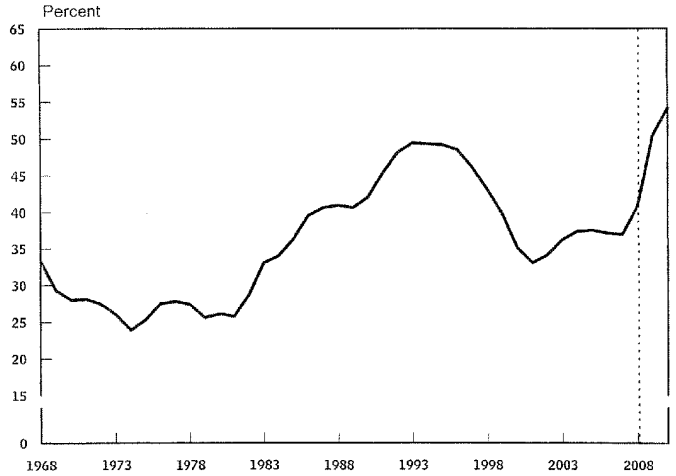
What Accounts for the Change in CBO's Estimate of the Deficit for Fiscal Year 2009?

Billion of Dollars

	2009
Total Deficit Projected in September 2008	**438**
Changes	
Lower revenues ($104 billion due to recent legislation)	362
Outlays for the Troubled Asset Relief Program	184
Outlays for recognizing the credit costs of Fannie Mae and Freddie Mac in the budget	218
Other changes in outlays	-16
Total Increase in the Deficit	**748**
Total Deficit Projected in January 2009	**1,186**

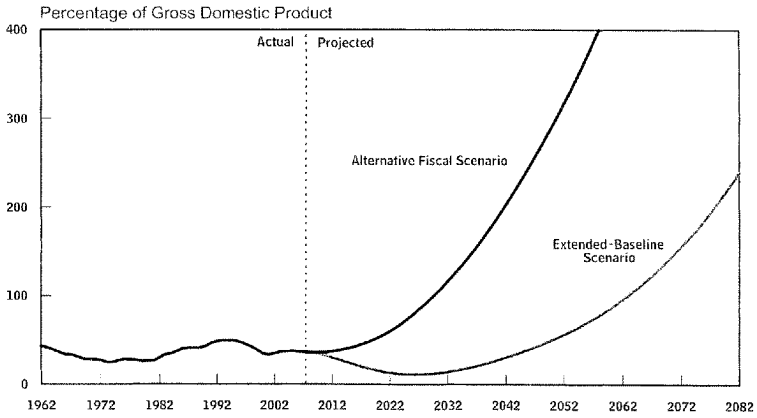
4

Debt Held by the Public as a Percentage of GDP, 1968 to 2010



5

Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios



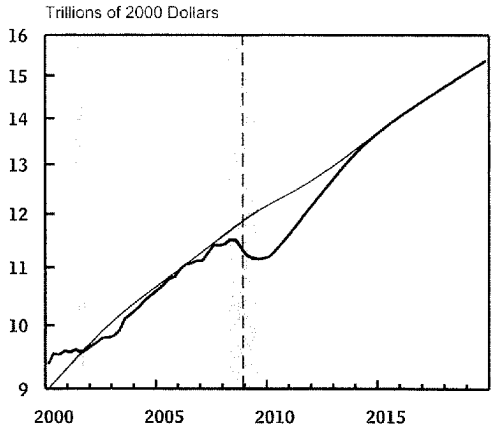
6

Selected Economic Projections

	Estimated	Forecast	
	2008	2009	2010
	Year to Year (Percentage change)		
Real GDP	1.2	-2.2	1.5
Consumer Price Index	4.1	0.1	1.7
	Calendar Year Average (Percent)		
Unemployment Rate	5.7	8.3	9.0
Three-Month Treasury Bill Rate	1.4	0.2	0.6

7.

GDP and CBO's Estimate of Potential GDP, 2000 to 2019



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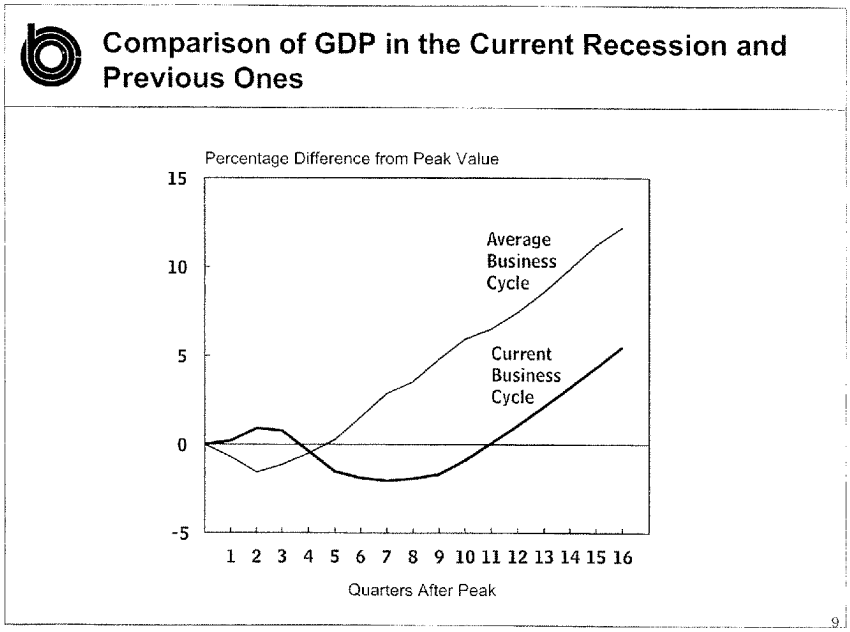


Chairman CONRAD. Let me ask you this: You have painted a pretty bleak outlook here. What is the risk that this downturn will be even more severe than you have described?

Mr. SUNSHINE. I think any of our economic forecasts are in the middle of a band of possible outcomes, and there is at least as likely—a greater likelihood that they will be—the outcome will be worse than we described as that it will be better. I mean, that is the kind of forecast we try to do.

Chairman CONRAD. Yes.

Mr. SUNSHINE. So that would argue that there is probably a 50-percent chance in our estimate that it would be at least somewhat worse than we predicted.

Chairman CONRAD. Let me just say that my experience with forecasts is they almost always miss at the turning points; that is, when things are going up, they underestimate how well things are going on the up side; when things are going down, they almost always underestimate how severe the downturn. And I used to have the responsibility for forecasting revenues for my State, and it is a very persistent pattern over time. It is part of human nature, I think. And so it seems to me there is a strong possibility, at least, that this downturn is more severe than you describe. I have had forecasts passed on to me by some in corporate America that see an even sharper downturn than is generally acknowledged.

What are the risk factors that you see that could lead to a more severe downturn?

Mr. DENNIS. Senator, maybe I can take that question. Clearly, one of the biggest risk factors is what developments are in the financial sector. There have been absolutely terrible things happening this fall, really very surprising things that few people were able to predict before they happened.

Things seem to be improving a little bit right now. The cost of borrowing that banks have to pay to each other to borrow overnight, which is one of the main indicators that we and others look at, that remains very high but has come down from the extraordinarily high levels that existed a month or so ago. So there are some signs of improvement there.

Nevertheless, I think we are very conscious of the fact that there has been a lot going on that we did not predict, and that really is a severe cause of possibilities of——

Chairman CONRAD. Well, let me ask one specific, if I could. We saw the unemployment for December rise very dramatically. The increase in unemployment for December was far higher than any forecast that I have seen. What does that tell you in terms of the potential for this to be a more serious downturn?

Mr. DENNIS. Certainly we saw both a very large increase in unemployment—a reduction in employment in November, and then another one looks as though it is coming in December, judging from yesterday's report from ADP. So those numbers are actually consistent with the forecasts we have given you, so they do not give you—they are not an indication that things would be worse than our forecast. But they do indicate the very severe decline that is occurring right now.

Chairman CONRAD. OK. Senator Gregg.

Senator GREGG. Thank you.

I want to get back to the economic stimulus and how it should be structured. I agree wholeheartedly with a lot of what you said, especially your last point that there cannot be long-term expenditure.

We did this $160 billion stimulus at the beginning of 2008, and a lot of it was basically a cash payment to people in hopes that they would expand consumption, but that did not happen. I tend to think that this recession is so unique in our history that the traditional Keynesian approach of just putting money in people's pocket and hoping that they spend it to turn the economy around is not going to be all that constructive. I think the most constructive thing we can do is look at the underlying causes, which are that our economy is not as productive and as competitive as it needs to be, and that we need use this situation to help us restructure the economy and make it more competitive; and that the majority of the initiative here should not be the expectation that we are going to be able to promote personal consumption, because I do not think that is going to happen. I think we could take all the TARP and all the stimulus, take $1 trillion and put it into consumption, I do not think it is going to affect the slowdown all that much, because I think people are in such a shell right now because of their concerns about the future that they are just simply going to save it or they are going to pay down credit card debt or they are going to do something that does not expand the economy.

So I think it makes more sense for us to use these dollars that we are going to put into the economy to restructure the economy. I mean, there is going to be a downturn more significant and severe than we have ever had since World War II. But as we come out of it, and we will, our restructured economy should be productive and more efficient. And so I would tilt heavily toward invest-

ment that created that type of a return versus stimulus that promotes consumption. Now, I understand it is classic economic theory that you put consumption on the table first to try to energize the economy.

Do you accept that theory at all? Or are you guys still in the place that consumption is what is needed?

Mr. SUNSHINE. Well, I think broad-based, for example, tax rebates, you run a serious risk, at least from the stimulus point of view, that a significant number of people will not spend them. The rebate last year, we had estimated that 40 percent of the amounts would be spent within 6 months. We do not know whether that turned out to be the case of not. It might have been less than that.

There are signs that the people are really pulling back and being very cautious, so the best way to get bang for the buck in terms of consumption is to target the money to the people who are most likely to spend it, whatever in your view that might be, whether it is unemployment benefits or other kinds of things that people who are most likely to be short of resources or credit-constrained. If bolstering consumption is a high priority, then that is the best way to do it, is to target it to the kinds of people who would spend it.

Another option that makes sure it gets spent is the Government spends it on—whether it is infrastructure, other kinds of investments that hopefully would enhance the future productivity of the economy.

Do you want to add something, Bob?

Mr. DENNIS. No. I think that is fair, and I do want to emphasize that we do not actually know yet what the impact was. There are some academic papers that address that question. One of them that we are aware of suggests a somewhat lower, 30 percent rather than 40 percent, spendout rate from it. But there are certainly concerns about that paper, too. So we really await the real studies.

Mr. Sunshine showed a graph earlier that showed that at the beginning of this recession there was a bit of an upturn in GDP, which is unusual in recessions. If we believe that our assumption of about 40-percent spending was about right, then what the stimulus would have done is give us that little bit of upturn at the beginning instead of having a GDP approximately flat for the first year of the recession.

Senator GREGG. Well, maybe, but I think we should heavily tilt the stimulus package toward investment-based activity—you know, bridges, roads, infrastructure, fiberoptics, whatever—that is going to give us a return. There may not be an immediate construction event, but in the long term, it is going to make us so much more competitive.

You talked about a big chunk of the increase in the deficit results from bringing GSEs onto the balance sheet. Is it $250 billion?

Mr. SUNSHINE. $240 billion.

Senator GREGG. $240 billion. Does that presume that that is sort of lost money? Or do we presume that we are going to get that back as an investment?

Mr. SUNSHINE. No, that is net-present-value kind of calculation. That captures the gap between their assets and liabilities by our estimate.

Senator GREGG. But we do not really know that. I mean, if the economy starts to recover and people start paying their mortgages, that number is going to drop pretty radically, right?

Mr. SUNSHINE. It could turn out better or worse than that.

Senator GREGG. Better or worse.

Mr. SUNSHINE. Yes.

Senator GREGG. Do you still perceive that the underlying generator of our really critical situation is the mortgage and housing industry? Do you see that, do your economists see that as being still the major problem? Or do you see this as having compounded into other things, credit cards and other areas?

Mr. SUNSHINE. Well, we can ask the economist.

Mr. DENNIS. It looks as though the recession has taken on a dynamic of its own. One thing to remember is that both the financial problems and also now the economic downturn is worldwide. It is all over the place. So we are going to be losing exports as well.

The loss of consumption means that there is much less incentive for businesses to invest, so you have got that dynamic going on as well. You see investment falling. One of the things we watch carefully is an index of architects' billings which suggest that commercial construction, which has held up relatively well, is going to join the parade of things that are going to be very weak.

There are all of these sort of normal dynamics of recession that are particularly strong at this time simply because the initial loss was large. We have lost a very large amount—consumers have lost a very large amount of wealth. That is also pushing down our consumption.

These are all ordinary mechanisms. Then you have got to add the question of possible credit constraints on top of that, and this is where you get into things like credit cards and so forth. We are not really forecasting that those things will get a lot worse, but they could. That is one of the risks.

Senator GREGG. That is interesting.

Should the stimulus package have in it aggressive enforcement mechanisms to discipline it, such as a hard sunset with supermajorities, such as entry tests as to whether or not spending on infrastructure has got a return value, for example—Main Street beautification versus building a bridge? Should we have that type of enforcement mechanism within the stimulus package?

Mr. SUNSHINE. As a taxpayer, I have some fears about what can happen when one suddenly throws large sums of money that—where one increases by large percentages the amount of money that the Federal Government or governments as a whole are spending in certain areas. The Federal Government is spending $60 billion a year, something like that, on infrastructure. So if we are talking about tens of billions of dollars, we are talking about a big increase in the amount that the Federal Government is contributing. And we are also talking about a lot of concern about making sure it is spent on things that are shovel-ready, that can start quickly.

As a taxpayer, I am not always sure that the things that are shovel-ready are necessarily the most important or most productive projects, and that it would seem desirable from that perspective for there to be various safeguards and controls built in to try and en-

sure that if we are going to put a lot of money into some of these kinds of things, that we spend it well, because I think there is a risk—particularly since there is such an emphasis on speed, there is some risk that we will not spend it well.

Senator GREGG. I will take that as an enthusiastic yes from a taxpayer.

[Laughter.]

Mr. SUNSHINE. CBO speakers are not supposed to give enthusiastic yeses.

Chairman CONRAD. Let me just enthusiastically endorse what the Ranking Member has talked about in terms of the targets of a stimulus package. I tell you, I thought the rebate thing was largely a bust. I have seen the paper, or my staff has, about only 30 percent of the money was actually spent. And however laudatory it is to save, to pay down debt, that does not stimulate the economy in this circumstance.

I am very, very concerned about some of these things that I hear about and read in the newspaper might be in this package. For example, a jobs credit, that strikes me—if I am a business person, it is unlikely, if you give me a several-thousand-dollar credit, I am going to hire people when I cannot sell the products they are producing. Why am I, if I am an automobile manufacturer, going to hire more people when the cars are not selling? That to me is just misdirected. I would much prefer, sign me up enthusiastically for what Senator Gregg has described as investment that is going to make us more efficient and more competitive. And I would put in that category—energy would be at the top of my list; infrastructure, and I think we absolutely should distinguish between types of infrastructure. There is certain infrastructure investment that will pay long-term dividends. There are others that are nice things but do not really improve our economic competitiveness. And then housing. Housing is still in the doldrums, still sinking. I just cannot fathom why that would not be part of this package.

Senator GREGG. Maybe the Budget Committee should come up with a useful set of criteria to help some of our fellow colleagues work on that.

Chairman CONRAD. Yes, I think that would be a very useful thing that we could do.

Senator Lautenberg.

Senator LAUTENBERG. Thanks, Mr. Chairman, and thank you both for being here, Mr. Sunshine and colleagues. The empty seats certainly do not indicate the concerns registered in the Senate. Unfortunately, I guess there is a lot going on that prevents us from being here, as I had another Committee meeting, but I think——

Chairman CONRAD. Senator, maybe I could just say, you have made an observation here that is important for us probably to relate. The Finance Committee is meeting right now, all members, on a stimulus package. So there are a fair number of our Committee members who are right now in that discussion.

Senator LAUTENBERG. Yes, we have had a very important discussion environment, and so it goes around as we are here.

Mr. Sunshine, your agency predicts a dramatic economic slowdown. That is consistent with the views generally expressed by knowledgeable people; GDP dropping by 2.2 percent in 2009. You

also cite prolonged struggles in the housing market and financial markets. Yet CBO comes along and then says in 2010 and 2011, we are going to see some growth.

Now, how do these things square? What is the basis for that conclusion that we are going to see economic growth resumed in 2010? And included in your answer, I would like you to just tell us whether or not you are expecting infrastructure changes. I am not just talking about highways and roadways. I am talking about the financial infrastructure of the country. So, if you would, please.

Mr. SUNSHINE. We have not built any legislative changes into our forecast in terms of whether it is financial infrastructure or other kinds of things. I will leave the technical details to Mr. Dennis. I would say the U.S. economy is, at its fundamental, a strong economy, and it hits these bumps in the road, and there is, you know, weakness in demand, and there are some things that occur and we have recessions. But ultimately, as the various—the economy by its very nature has an ability to recover. Now, what it has to recover from this time is more severe than what it usually has to recover from. We have had an enormous loss of wealth on people's parts. We have had the great strain in the credit markets, people having trouble being able to finance their homes and get all other kinds of borrowing.

But, fundamentally, the economy will turn around, and the question that we have to grapple with as forecasters is when. Will it turn around in 6 months? Will it turn around in a year? Because the fundamental dynamics of the economy are such that it does turn around.

Did you want to give a more technical answer to that?

Mr. DENNIS. Not a more technical answer, but maybe just one other point. We do not try to forecast what changes are going to occur in the financial markets, but we are certain that there will be changes, that the financial markets a year from now will not look as they do now and will not look——

Senator LAUTENBERG. They will not look at?

Mr. DENNIS. As they do now, and——

Senator LAUTENBERG. As bad——

Mr. DENNIS. We hope they do not, and also after the recession, the financial markets will not look the way they did before the recession. We would not expect, for instance, to see the subprime market work the way it did before. There may well be changes in the securitization of mortgages and the rules that go along with that. There are a number of different things that we would expect to change. Maybe there will be different regulation of banks. All sorts of things are likely to change. We are not sure what precisely are the contours of that. We do expect that there will continue to be some uncertainty about the financial markets persisting for quite a long time, and that is one of the reasons why our forecast is that the recovery from recession will be somewhat slower than is usual. Maybe the analogy would be to go back to the headwinds that Chairman Greenspan talked about a couple of recessions ago.

Senator LAUTENBERG. Slower than——

Mr. DENNIS. Frequently——

Senator LAUTENBERG. Is a year from now a quick or a slow pace?

Mr. DENNIS. Well, I am really thinking about after the recession; that is, there is a recovery period after the recession where we frequently have growth rates on the order of 6 percent, and that is not our forecast. We have got them more like 4 percent, which is only a little bit faster than the growth of potential in the economy.

Senator LAUTENBERG. I heard Mr. Sunshine talk about his concern as a taxpayer. We all do the same thing here and are concerned about Government spending. Did I hear you correctly?

So how do you feel about the stimulus as a general thing? Not having been here, I am sorry that this might be repetitive.

Mr.SUNSHINE: I mean, CBO does not, of course, make policy recommendations. We pointed out in our report that the economic situation now is of the type where fiscal stimulus might be beneficial, that the economy is operating at a very large percentage, from a historical perspective, below its potential capacity. And there is a great loss of output occurring as a result of that.

It is also not clear that the very aggressive actions on monetary policy and the various things that the Federal Reserve is doing to stabilize the financial system, whether that will be sufficient both to stabilize the financial system and to stimulate the economy and create additional demand because of the constraints of the financial system. So using the various criteria one thinks about, as the situations with fiscal stimulus might be desirable, most of them apply in the situation perhaps better than in many other situations.

The other condition is that we expect the period of either recession or slow growth to be longer than in most situations, because in a short recession, by the time you implement fiscal stimulus, it can easily be too late, and you actually—and the stimulus kicks in after the recession is over and does more harm than good.

If, in fact, you think there is going to be a long period of either recession or slow growth, that makes a stronger case for doing things that can kick in, in 6 months or 8 months or a year.

Senator LAUTENBERG. Can I ask for just kind of a yes or no type answer? Do you think that we could get along without a stimulus package or a stimulus injection in the economy?

Mr. DENNIS. Our economic forecast does not assume a stimulus package, so I think that is a judgment that you would have to make.

Senator LAUTENBERG. Yes, but you are making a forecast.

Mr. DENNIS. Right.

Senator LAUTENBERG. You are taking the data from which you make your conclusion. By the way, do you use any of the labor statistics that we see now coming on a regular basis in terms of your forecasts of job growth, income levels, et cetera, et cetera? Do you use that kind of mechanism in developing your forecasts?

Mr. DENNIS. We absolutely do, yes.

Senator LAUTENBERG. Which index do you use; do you know? Is it the Bureau of Labor Statistics?

Mr. DENNIS. We use a lot of things. We look at the Bureau of Labor Statistics stuff. We also, for instance, looked at the report yesterday that tracks payrolls that gives us——

Senator LAUTENBERG. What is the firm?

Mr. DENNIS. ADP. It gives——

Senator LAUTENBERG. I am one of the founders of that firm.

[Laughter.]

Senator LAUTENBERG. And Alan Greenspan came to the Fed from our board. And I worked for over 20 years to get that index going, and I could not get the team to do it. Finally, now that I am far enough away—but they got it done, and I think——

Mr. DENNIS. We thank you very much.

Senator LAUTENBERG. I am pleased that that company that was started with nothing—and I do not want to take too much time. I do want to, but I will not.

[Laughter.]

Senator LAUTENBERG. But the company that was started by three young people from Paterson, New Jersey, without any resources at all now produces an index that provides the freshest data that are available. It is weekly calculations, what incomes are, what terminations there are, what new hires there are. And I am not looking for an endorsement, I promise you, because they do not sell it. They give it away. In my day, I would have sold that information.

You have said—and I think I heard you correctly—that you do not include the stimulus package in your forecast.

Mr. DENNIS. That is correct.

Senator LAUTENBERG. Then a stimulus package ought to blow the top of things, if stimulus works at all. Can stimulus be a negative thing in our change of direction?

Mr. DENNIS. We would anticipate that a stimulus, unless it was designed in a very odd way, would be a stimulus as to the economy, yes. How much stimulus there would be would depend very much on the design of the package.

Senator LAUTENBERG. Mr. Chairman, I have taken advantage of the time. Are we——

Senator GREGG. I wish I were Chairman, but the Chairman has left and asked me to watch the time, and I——

Senator LAUTENBERG. I am being nice.

[Laughter.]

Senator GREGG. That is very kind of you. Very kind.

Senator LAUTENBERG. Am I out of time?

Senator GREGG. I think so.

Senator LAUTENBERG. OK. Thank you. I will submit some questions for the record, and I appreciate it. Thank you.

Senator GREGG. I would like to second your support of ADP and the great job you did in creating that company. I was a stockholder at one time of that company. Very excellent income.

Senator Sessions.

Senator SESSIONS. Thank you, Senator Gregg, and I thank Chairman Conrad for the hearing and for the nice discussion that we have had.

Mr. Sunshine, I particularly appreciate the fact that you have explained our economy in a dispassionate way. You do not seem to be totally panicked, but instead appropriately concerned, and in a way that the average person could understand. I hope a lot of people have heard that.

I saw an article in USA Today, when this thing began that kind of began to show these problems and it made the comment that an economy built on excessive Government debt, excessive personal

debt, and a tremendous trade deficit is not a healthy economy. It does seem to me that the debt problem, the leveraging problem, is out there across the economy, I think as you suggested, Mr. Dennis, more than just the mortgages. Many people with big credit card debts and personal debts have taken out second mortgages reducing their home equity. And we have been living on that debt.

Is it true, Mr. Sunshine, that this increasing debt has been the fuel that has sort of created some of this bubble?

Mr. SUNSHINE. I certainly——

Senator SESSIONS. If we can use that phrase, "bubble."

Mr. SUNSHINE. I think we certainly saw it in the housing area in particular. The availability of new kinds of mortgages, the availability of mortgages to people without careful checks as to whether they could afford to pay them, coupled with low interest rates during that period, drove housing prices higher, put people in homes that they could not afford to pay for. And part of the process we are going through now is getting back to a more normal kind of situation. And I think some of that kind of reliance on debt has occurred in other sectors of the economy as well.

Senator SESSIONS. Well, I have been working with Senator Kennedy—which has not yet reached fruition—on a plan to create a universal savings plan in addition to Social Security for every worker in America. And we were aware a little over a year ago that the savings rate in America was below zero, a 1-percent erosion of a person's net wealth every year because they were spending their wealth down.

Well, when the price of your house drops and you have been already eroding that equity or increasing your debt, we get in a circumstance that is not healthy, I think. Now I understand that already the savings rate is 3 percent. I talked to one economist yesterday who said they are projecting it could rise to 8 percent—which in the short run might be bad, but in the long run might be healthy.

Would you agree with that, Mr. Sunshine?

Mr. SUNSHINE. That is right. Ultimately, in order to have a more productive economy, we need over the long term more saving and more investment than we have historically had. As you pointed out, there is a conflict between what we might need in the very short term and what we need in the long term. But the need for greater saving and investment over the long term is clear, particularly in view of the long-term budget/fiscal problems that we face as a Nation.

Senator SESSIONS. Well, I could not agree more with that, and I just know that we have got to work out—so, first of all, to take the panic out of the situation, it would seem to me that we are going through a recession that might also be called an adjustment, a readjustment to a more normal saving/expenditure/consumption scenario based on the net income that Americans have. And this is very painful for us right now, but it is not all bad. And at some point, as we come out of this, a recession or an adjustment gives us the potential to begin an economic growth that could carry us for years to come. Is that the hope, Mr. Sunshine, would you say?

Mr. SUNSHINE. That is definitely the hope. I mean, our economy and other economies go through bubbles of various types. We have

had some before. The housing bubble was an enormous one and spread throughout the economy and struck at the financial system as well, and we are going through an adjustment. And, in fact, you know, we predicted house prices will continue to decline because they have to get back to the point where the level of house prices corresponds to the level of people's income so that they can afford to buy them. And ultimately the housing market will not settle until we get some kind of equilibrium between where people's incomes are and where house prices are. And the economy has to go through that adjustment.

Senator SESSIONS. You mean we just cannot pass a law and make the housing prices stay where they are and not adjust?

Mr. SUNSHINE. That would be tempting, I suppose.

Senator SESSIONS. Well, I mean, we do need to understand that. I do believe that we have sort of been in a panic mode. I did not support President Bush's "send out the check" program, and I think the chart that was shown earlier indicated that it did not do much for the economy. I did not support the TARP program, but I know the reason it was passed, and it was a difficult decision to oppose it. And I have heard a number of economists recently say that the way it was executed has not really solved the toxic mortgage problem. We have still got to deal with that, regardless.

We do not need to make mistakes in the future, as you have said. Whatever stimulus we undertake should be a stimulus that works. I notice you made the comment, Mr. Sunshine, that we have got a $60-billion-a-year infrastructure program. It is something I have been looking at before this hearing. Many of the proposals are, "Oh, well, we will just spend $350 billion in the next 2 years on roads and highways, and nobody can object to that, and that will be very popular. OK?" But $350 billion is $175 billion a year. That would be nearly three times the current rate of expenditure for infrastructure from the Federal budget. And I just cannot imagine that can be spent efficiently, and there are just not enough cement mixers to make it work without surging prices unnaturally. So we have really got to be careful about that challenge.

I do not know if my Chairman is coming back. Do you expect him—oh, I see. Senator Whitehouse, I would be pleased—my time, I think, is up. I would—maybe one more thing.

Senator WHITEHOUSE. Senator Sessions, there is only me waiting, so feel free to take your time and continue to the end of your questions.

Senator SESSIONS. All right. I think it is very instructive—very instructive—when we consider the enormity of what we are doing, to consider what you said earlier, Mr. Sunshine, that basically Freddie and Fannie need to be on the Federal budget. They are Federal programs. I do not know if we have ever discussed that in any open, rational way in this Congress. But it is just one of the huge things that is occurring at this point in our history without much discussion by our political leaders. We have just got to pay more attention to it.

And with regard to the debt that Senator Gregg spoke about, I was very troubled, and President Bush was criticized greatly for a $412 billion deficit in fiscal year 2004, the largest since World War II. It dropped to $161 billion in 2007. We were making some

progress. Last year it was $455 billion, the largest ever. And now you are projecting, with no stimulus package, a $1.2 trillion deficit this year and a $1.8 trillion deficit if the stimulus package passes. And I guess I would just say those concerns add cost in the long run to this economy. Those debts are burdens this economy is going to have to carry, and we should keep this thing as lean and as productive as absolutely possible.

Thank you. I would yield my time to my colleague.

Senator WHITEHOUSE. Thank you, Senator Sessions.

For people who are still watching, I guess I would like to make an initial point, which is that this discussion matters a great deal not just to CBO economists and Senators on the Budget Committee and economists around the world. It is not a hypothetical future problem. It has very immediate and real consequences. One of them is in the last year's budget that we approved, there was $260 billion in interest expense to pay for this deficit. And we have calculated that for that $260 billion, you could provide universal health care in America. And on top of the universal health care you could provide in America, you could double Pell grants for kids going off to college in America. And on top of universal health care and doubling Pell grants, you could double the Head Start program. And on top of universal health care and doubling Pell grants and doubling the Head Start program, you could fix 95 percent of the bridges that have been identified as needing repair in this country.

That is what you could do with that $260 billion, and I would say that if you were President and you came out with universal health care, doubling of Pell grants, doubling of Head Start, and repairing 95 percent of the bridges that need repair in this country, that would be a pretty good success to be able to claim. And we prevent it, we prevent ourselves from accomplishing it by running these deficits and facing that interest expense. The interest expense is likely to get worse rather than better, as interest rates begin to increase and as the underlying deficit explodes, so that real cash budget annual cost of this thing that affects people in their lives and homes is very significant.

The second point that I would like to make is that we have calculated in my office with the support of the Budget Committee staff, that the Bush administration ran up a $7.7 trillion net deficit compared to CBO projections of the budget on the day that the Bush administration took office, and that $7.7 trillion, that is a 7, and then another 7, and then 11 zeroes, if anybody wants to try to write that down. I mean, it is a frightening number. I am from Rhode Island. We barely get into billions. $7.7 trillion blown in essentially robbed money taken away from the American people to the extent they are entitled to a balanced budget is a big number, and that, by the way, is the number before the bailouts began. The bailouts have only added to it.

So in the boom economy, at the time when common sense and prudence dictate that we should have been setting money aside and protecting ourselves economically, we made—or the Bush administration in particular made reckless financial decisions that have made it, I believe, much more difficult for us to respond to this now. If we were running a surplus and we were going into this, we

would be in much better shape, and we had surpluses anticipated for this period until the Bush administration came along. The Clinton administration left in good fiscal shape this country, perhaps partly because when they came in, they had in the campaign office that famous slogan, "It's the Economy, Stupid." I would suggest that if we were to discuss "It's the Economy, Stupid" now, we would want to add "It's Health Care," because there is this catastrophically large health care liability that we are facing out there. And if we do not get our arms around a significant delivery system reform of the health care system quickly, then we are going to be swamped by that in ways that I think make today's concerns, as serious as they are, look mild by comparison.

The last point I will make—and then I will throw it to you to comment on any and all of them as you please—is that as long as we are looking at infrastructure investment and a stimulus, and as long as we are looking at a very substantially bad deficit picture for our country going forward, it strikes me—and I guess I will make this a question to you.

It strikes me that if we are going to have to do stimulus spending to protect the economy from much deeper disaster than would happen otherwise, and if we are in a very bad deficit environment, it makes sense to do as much of the stimulus as you can for infrastructure on two grounds:

One, you probably are going to have to pay for the stuff anyway, sooner or later, so why not do it now and front-load it into the stimulus?

And, two, when you are done with it, you have a tangible asset. In a probably non-economic or accounting sense, you are actually taking kind of a cash asset or expenditure of the country and moving it to become a tangible asset of the country's and not making the country any worse off, assuming that you are spending wisely. If you are spending very wisely, you could actually make it much better off because it can be a wise capital expenditure.

So starting with your comments on how stimulus investment in infrastructure is a better—or worse, if you think so—stimulus investment in our deficit environment and commenting on any of those other points, the floor is back to the experts. I appreciate your testimony, and I join everybody else in thanking you for how hard you worked in holiday timeframes to get us to this point.

Mr. SUNSHINE. Thank you. I think stimulus infrastructure investments have value in this kind of environment because of what we have talked about before in terms of the long-term fiscal problems facing the country. And if you can do things that both stimulate the economy and make it more productive in the long term, that is the best possible combination. The challenge is to find the infrastructure investments that actually do that, and that is not so easy when you are trying to do it quickly and trying to infuse a lot of money into the program. But if you can do it right, infrastructure investments, many of them, do have a positive return, and they do enhance the productive capability of the economy.

Senator WHITEHOUSE. Let me ask you a little bit about that, because it strikes me that a stimulus has two effects. It has a cash effect of putting money out into the economy quickly, but presumably it also has a confidence effect. There are evidently 200 projects

backed up in Rhode Island, which is not a very big State, for water infrastructure that amount to $900 million. If you are involved in companies that support that kind of construction, if you are a carpenter or in the cement business, if you are an electrician and plumber and involved in all of that, it strikes me that if you know that we can get 200 projects working, that there is going to be $900 million spent, you may not have that money in your paycheck right away; but if you are working on those projects and you know that they are going to be seen through and they have got the Federal Government behind them, you might just take that creaking washing machine and go out and buy a new one just on the confidence that you have a job through this period. And I would love to hear your comment on the difference between the immediate cash effect of stimulus and the confidence effect of stimulus when it is related to a job and somebody can say, "Whew, OK, I am going to get through this all right. I am not going to have to freeze my personal spending. We can get the new washing machine."

Mr. SUNSHINE. Often one of the concerns we raise about infrastructure investment in a short recession is you have got to be careful if, by the time they actually start spending the money, you miss the recession and it happens too late.

Senator WHITEHOUSE. Not likely to happen now.

Mr. SUNSHINE. But in the period we are talking about now, there is much more time than we would—unfortunately, there is more time for that to happen. And I think your point is well taken that the expectation or the certainty that there will be projects or—I mean, some of these projects actually take a year or 2 years or 3 years to do. So it is not just someone going out and getting a job for a month. It is someone knowing that there is this project going on for 2 or 3 years. And that is, I think, a lot different than getting a check once.

Mr. DENNIS. Can I just add that there is another confidence effect, too, and that is that the company, the construction company that might be involved may be much more likely to buy another truck or——

Senator WHITEHOUSE. Cement mixer, yes.

Mr. DENNIS [continuing]. A road sweeper or something if they are confident they are going to be able to use it.

Senator WHITEHOUSE. I appreciate it. I have gone over my time, which I was doing happily and willingly because I was at the end of the line here. But one of my very distinguished senior Senators, Senator Wyden of Oregon, has appeared, so I will yield the floor, and given his seniority, I will also yield the gavel to Senator Wyden of Oregon.

Senator WYDEN [presiding]. I thank my friend, and I always miss hearing Senator Whitehouse on the budget, and I will catch up.

Senator Sessions would like to ask I think at least one additional question, and then I will wrap it up. Senator Sessions?

Senator SESSIONS. If you need to go first——

Senator WYDEN. No, why don't you go first.

Senator SESSIONS. Just one little issue—which is not so small, I guess—that is, the impact of the debt and the trade situation with China that our Chairman Senator Conrad raised, "China Losing Taste For Debt." It just notes in this New York Times article

today—or yesterday, that the trade surplus in China this year is $20 billion a month, whereas last year it was $50 billion a month. It is that surplus, is it not, that they have utilized much of to purchase securities in the United States?

Mr. DENNIS. Yes.

Senator SESSIONS. That is the substance from which they are able to do it.

Mr. DENNIS. Yes.

Senator SESSIONS. So we can see they will be buying less. Of course, we are talking about a $1.8 trillion addition to the debt in 1 year, this year, based on your projections. I would like to inquire a little bit more about how this impacts us. Isn't it true that right now, Mr. Sunshine, we are benefiting from very low interest rates?

Mr. SUNSHINE. That is correct. Very low.

Senator SESSIONS. Very low. Unprecedentedly low. Have you made projections about how those interest rates might grow? And is there a danger that they could surge beyond what we would normally expect to be the case?

Mr. SUNSHINE. Well, I think we project them to return to a much more normal level over the next 2 or 3 years. We have not projected an extraordinary uptick in the interest rates over this period to beyond what one would consider normal.

Senator SESSIONS. But the money has got to come from somewhere. So if all nations are showing a reduction in their surpluses—of course, we have a trade deficit—it could create a situation, could it not, that we might see a surge from extraordinarily low to maybe extraordinarily high interest rates to finance this debt around the world?

Mr. SUNSHINE. I mean, we have a 3-month treasury bill rate over the 2011–14 period going back up to 3.8 percent—it is now less than a half—and going up to 4.7 percent over the latter part of the 10-year period.

Senator SESSIONS. And what is the interest on the debt today, the $10 trillion or so that we have today?

Mr. SUNSHINE. About $200 billion.

Senator SESSIONS. $200 billion.

Mr. SUNSHINE. Again, it is unusually low, Senator, because the interest rates on the short-term debt are so low.

Senator SESSIONS. And what do you project on your out-years for the interest payment on the debt?

Mr. SUNSHINE. We have going out in the later part of the 10-year period around $450 billion a year.

Senator SESSIONS. $450 billion every year, Mr. Chairman, on the interest on the debt, is equivalent to almost an entire cost of the 5-year Iraq war. And if the interest rates were to go higher and some of that debt has been locked in low, it may well begin to inch up even more in the out-years.

That is some of the reason, one of the reasons, I assume, that you are concerned about increasing debt.

Mr. SUNSHINE. Again, part of the problem is not the 10-year period by itself, but what happens in the following 10 years and the following 10 years. And we are not in a situation where we can, well, it is OK if we have some high debt now, things will get better.

We are in a situation where things are going to get worse unless actions are taken to change the nature of our fiscal policy.

Senator SESSIONS. The fundamental nature of our fiscal policy.

Thank you, Mr. Chairman. This was a sobering discussion, I thought, and I am glad to participate and have that time.

Senator WYDEN. And I appreciate my colleague's thoughtful questions.

Mr. Sunshine, CBO has correctly identified health care spending as the biggest driver in long-term Federal spending growth. At the same time, CBO has now proved that it is possible to significantly expand health care coverage and do it in a revenue-neutral way if you changed the incentives that drive behavior in the American health care system. And I say CBO has proved this because that was what was done in the analysis that the agency sent to myself and Senator Bennett last May. The agency analyzed our Healthy Americans Act, a piece of legislation cosponsored by, on this Committee, Senator Gregg and Senator Crapo and Senator Stabenow and Senator Nelson. We very much appreciated working with the agency on that bill.

But what I want to ask about is the tax provisions, Federal tax provisions of health care. It is the single biggest item of health care spending. It comes to about $247 billion. This is stemming, of course, from the systems set up after World War II when there were wage and price controls. And, in my view, it is absolutely key that it be changed because it rewards inefficiency and is regressive in nature.

My question to you is: Is there any other area of Federal spending—and this is, of course, a tax expenditure—that is close to being as big, No. 1, and, two, as readily available for expanding coverage as that particular set of provisions—the provisions that make it a write-off for business and tax-free to the worker? Is there any other provision of Federal spending or tax expenditure that is close to being as big or as readily available to expand coverage?

Mr. SUNSHINE. Just on the tax side?

Senator WYDEN. Yes.

Mr. SUNSHINE. I do not know the answer to that.

Senator WYDEN. I do not believe there is anything close.

Mr. SUNSHINE. Mortgage interest is big, but that is not something one would want to use for this kind of purpose.

Senator WYDEN. With respect to health care. And the reason——

Mr. SUNSHINE. Oh, no. That is by far the biggest impact with regard to health care, sure.

Senator WYDEN. The reason I am asking the question is I read both of the CBO budget books with respect to health care. A couple of times my spouse had to nudge me to keep me awake.

Mr. SUNSHINE. I can understand that.

Senator WYDEN. They are wonderful documents, but it is dense. I cannot find anything in the health care arena—certainly mortgage interest and the like—that is as close to being as large and as readily available to expand coverage. And I gather now on the basis of your answer you agree.

Mr. SUNSHINE. That sounds right.

Senator WYDEN. OK. In terms of provisions that change the incentives that drive behavior in health care markets, are there any other major provisions?

Mr. SUNSHINE. I am not sure I understand the question.

Senator WYDEN. Well, I could see how if you put copays on a particular service, that would, for example, change behavior and the incentives in the system. But I did not see any in the CBO books that were as close to as large as the Federal tax cut provisions.

What I am trying to get my arms around is we are going to try to pass a bipartisan health reform bill, and in tough economic times, you are going to have to find major sources of money in order to facilitate a transition. And I do not see anything as close to the amounts in the Federal tax provisions that we are discussing. Is that right?

Mr. SUNSHINE. That sounds to me like, yes, a very significant pot of resources that one can think about in terms of changing incentives that face people.

One thing that is clear to me from the work we have done on health care is that you cannot address the problem just by tinkering around the edges. And we have a book full of ways, many of which are tinkering around the edges, some of which are fairly significant changes. But if you want to change both the effectiveness of the health care system and the coverage of people, I think the only way you can do it is by making very significant changes in the whole structure of the system. Minor tinkering will not take that curve that I showed earlier in the hearing and bring it down.

Senator WYDEN. Well, what else moves health care markets in a major way besides the Tax Code? I mean, that is what we want to do. That is what the bipartisan sponsors of this legislation want to do. And it does allow us to meld together democratic thinking and Republican thinking. I mean, Democrats have fought—and, in my view, correctly so—to get everybody covered. It is the moral thing to do, and it is also the economic thing to do, because if you do not do it, the people who are uninsured shift their bills to the insured. So Democrats have been right there, and Republicans, in my view, have contributed significantly to this effort to fix the markets and particularly to make sure that health care is not just handed off to the Federal Government. I do not see anything that does that more quickly than making changes in the Federal Tax Code, and I want to, before we wrap up—and as I say, we have been very grateful for our work with all of you. I think you have probably given us more hours than everybody else combined on this task. I want to see if there is anything else that makes markets here.

Mr. SUNSHINE. I do not know if it is in terms of money. In terms of one has to focus on the incentives that face all the players in the system, the people that provide the services and people who use health care services. And we need to look at ways to encourage providers to use the most effective methods and to not use things—not to overuse techniques or services. You need to encourage users to be prudent in how they use the system. And I think the structure of the tax system has an effect on that. The extent to which people understand or perceive that they are paying for health care in various ways that right now are sort of invisible to them, and

making those visible and providing people incentives to choose among health care plans in ways that give them the most effective health care but do not encourage them to buy lots of expensive health care that they might not necessarily need.

Senator WYDEN. What I found striking about the two CBO budget books on health is that there were a number of modest steps—steps I happen to support. I mean, certainly if you are well off, there ought to be some copays. You know, Donald Trump will be on Medicare before too long, and certainly he should face some payments for his Medicare that someone with a very modest income should not. So CBO essentially outlines some options like that.

CBO also outlines some options, for example, in terms of health information technology. I think in the short term it is probably in the vicinity of $10, $12 billion worth of savings in terms of implementing reforms in that area as we get rid of paper records and make it easier for doctors not to repeat tests and that sort of thing.

But none of that comes close to the kind of market-making, incentive-changing activity that you will see by reforming the Tax Code as it relates to health care the way four members of this Committee are seeking to do.

Does your colleague want to add anything on this point? Or do you want to be spared and pretty much liberated to go to lunch here?

[Laughter.]

Mr. DENNIS. I am not sure I have anything to add, Senator.

Senator WYDEN. OK. Mr. Sunshine, we may have colleagues who want to ask questions for the record. We appreciate your work and hope that you will be staying on, because I think you perform a great service to the country at CBO, and particularly your new approach in terms of health care is particularly welcome. I have always felt that the history of health reform is that Members of Congress, like those of us on the Healthy Americans Act, we go off in our offices, and we draft these pieces of legislation, we propose them, and eventually they go off to CBO to die, and they die a sort of unglamorous, obscure kind of death. But the fact that CBO has been willing to work with Members of the U.S. Senate on a bipartisan basis, particularly on these matters of changing the incentives that drive the behavior in the health system, which we all understand is the biggest single driver of health costs, is enormously important. So, from my standpoint, be excused knowing we are very grateful for the approach that we have seen in recent years where the agency has been willing to work with Senators on both sides of the aisle on these tough issues.

Mr. SUNSHINE. Thank you. We have a very capable and much larger health analysis staff than we used to have, and we look forward to working with you and the other members in figuring out good ways to address the Nation's problems in this area.

Senator WYDEN. And I will close by saying your thinking is clearly spreading in the Congress. I was thrilled that Chairman Baucus, who has done very good work on this health reform issue, has also put out in his White Paper, a very constructive document on health reform, his interest in looking at the tax side of health care. So your efforts are paying off. Senators with gavels in their hands,

like the Chairman of the Finance Committee, are paying attention to your work, and we thank you for it.

You are excused. We are adjourned.

[Whereupon, at 11:50 a.m., the Committee was]

Statement by Senator Russ Feingold
Senate Budget Committee Hearing
CBO's Budget and Economic Outlook: FY 2009 to 2019
January 8, 2009

Chairman Conrad and Ranking Member Gregg, thank you both for convening this hearing to hear from the Congressional Budget Office on their latest report on the federal budget and the nation's economic outlook. As we embark on a new fiscal year and confront perhaps the most serious budget situation facing the nation since World War II, it is at least reassuring that you two are at the head of the committee charged with overseeing the larger budget picture.

Nevertheless, despite the commitment of our Chair and Ranking Member to fiscal responsibility, the budget challenges projected over the next ten years in this report are staggering. And that is without taking into account the uncertainties in this report's projections – uncertainties that may in fact have produced projections that, as bad as they are, may be overly optimistic.

That was what happened in 2001, when the Budget and Economic Outlook report projected budget surpluses for the decade to come. As laughable as it may seem in retrospect, some credible observers actually spent a great deal of time worrying that our budget surpluses would be so large and ongoing, that we might actually pay off our government debt entirely, and then be forced to buy real assets in the private markets with the remaining balances.

That was the argument underlying former Federal Reserve Chairman Greenspan's testimony before this committee back then, and it led to one of the most prescient comments I've heard since coming to the Senate when our former colleague Senator Sarbanes noted that he feared Chairman Greenspan had taken the lid off the punch bowl.

Punch bowl indeed, Mr. Chairman. The fiscally reckless policies that flowed from that time certainly had a drunken character to them. And those fiscal policies, combined with the irresponsible deregulation of our financial markets, deeply flawed trade policies, and perhaps the greatest foreign policy blunder in the history of our nation, helped lay the groundwork for the budget disaster we now face.

When he takes office in less than two weeks, President-Elect Obama will be in the deepest budget ditch presented to any President in our history. At the same time he has been handed an economy in severe recession, and financial markets that lack the transparency and reliability needed to function in a free market.

This singular situation will mean having to take some extraordinary fiscal action to jumpstart the economy. But that does not mean we should abandon long-term fiscal

discipline. Supporting an economic recovery package doesn't mean we should support any new spending or tax cut proposal that is offered. It's all too easy to use this dire economic situation to justify a favorite proposal, especially as we are asked, for the sake of stimulating the economy, to suspend the usual budget rules requiring deficit neutrality.

Rather than taking the lid off the punch bowl again, we should be doing just the opposite – redoubling our efforts to crack down on the kinds of abuses that have contributed to the current mess. I have been pleased to join in a bipartisan effort to crack down on unauthorized earmarks slipped into appropriations bills, and I know there are other reforms that we should review as we consider the economic recovery package that is presented to us in the next few weeks. I strongly favor incorporating those reforms in any recovery package we pass.

Thank you again, Chairman Conrad and Ranking Member Gregg. I look forward to hearing the testimony of our witness.

THE DEBT OUTLOOK AND ITS IMPLICATIONS FOR POLICY

THURSDAY, JANUARY 15, 2009

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

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

Present: Senators Conrad, Wyden, and Gregg.

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

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. I want to welcome everyone to the Budget Committee today. The hearing this morning will focus on the debt outlook and its implications for policy. We have a distinguished panel of witnesses. They are: Dr. Richard Berner, the Managing Director and Chief U.S. Economist at Morgan Stanley; Dr. Allen Sinai, the President and Chief Global Economist and Strategist at Decision Economics; and Dr. Douglas Holtz-Eakin, well known to this Committee as a former Director of the Congressional Budget Office, who is now President of DHE Consulting. And we welcome you all. We especially want to welcome back our friend, Dr. Holtz-Eakin, who did such a professional job at the Congressional Budget Office, and we thank him for his service.

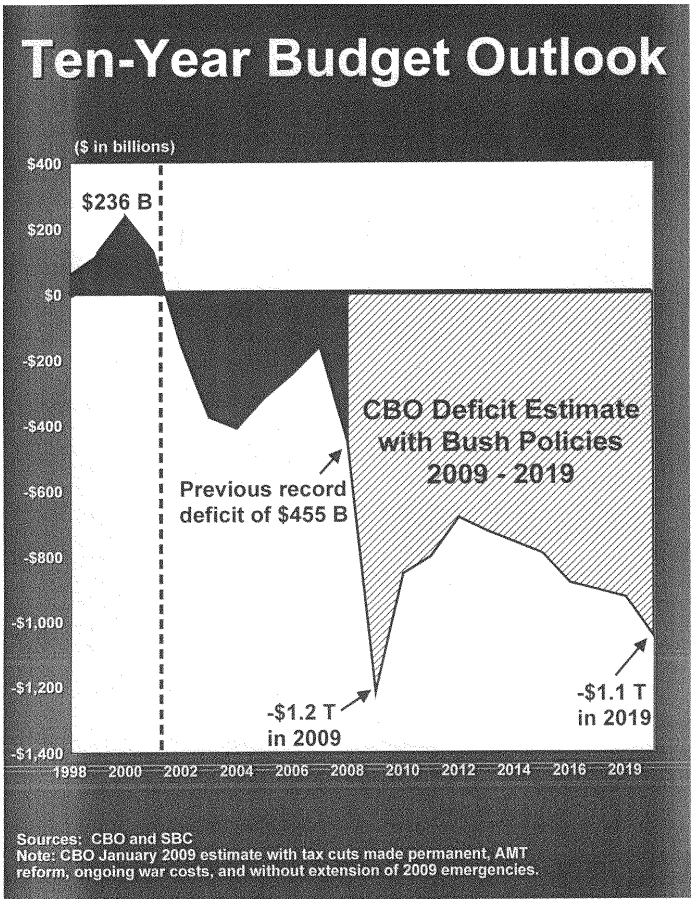
I am pleased that all of you could be with us today. I look forward to your testimony. As I have stated before, I believe that the buildup of Federal debt is the single biggest threat to our Nation's long-term economic security. Obviously, we have a near-term threat in this sharp slowdown, and first things first. We have to deal with that. We have to put in place an aggressive economic recovery program. But at some point we are going to have to pivot and face up to this burgeoning debt.

The main questions I would like to discuss with our witnesses today are: Does the current buildup in U.S. debt threaten the creditworthiness of the United States? Is there a tipping point where the debt becomes too large in proportion to the size of our economy? And what would be the consequences to the economy and to the budget of a bursting or a deflating of a debt bubble at some time in the future?

Again, I want to make very, very clear that we understand on this Committee fully the need to have an economic recovery package that will add to deficits and debt in the short term. But this Committee also has a responsibility to our colleagues and to the country to put a focus on the unsustainability of our current fiscal condition, especially in the long term. Given the retirement of the baby-boom generation, given the sizable additions to the debt that have already occurred, we need to help our colleagues understand what the risk is of a failure to address our long-term imbalances.

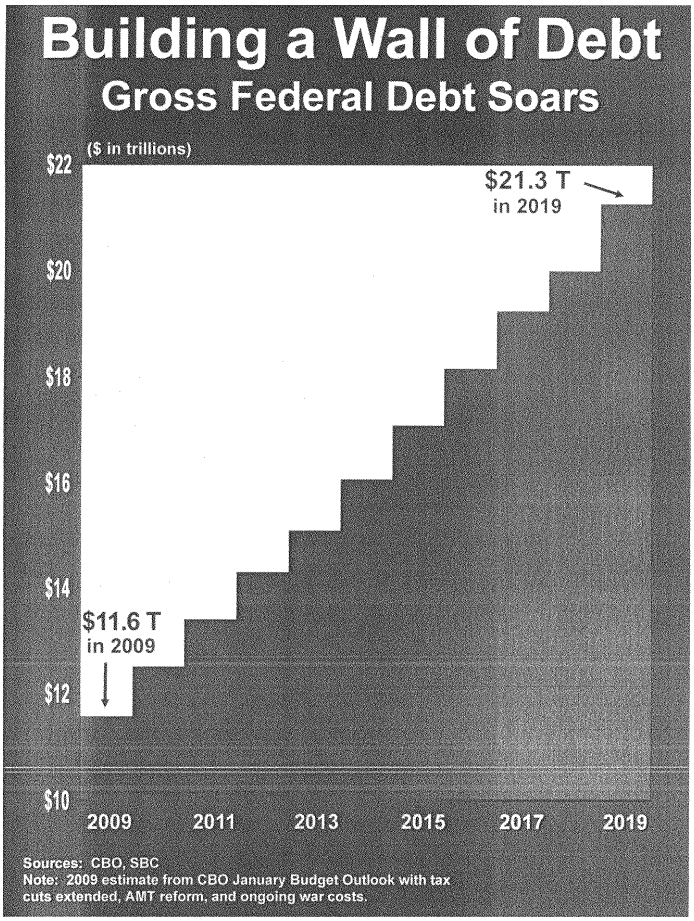
The news we received from CBO last week about the deficit was jaw-dropping. We faced one of the worst budget forecasts I have

ever seen. CBO's new estimates show the deficit in 2009 will be $1.2 trillion, but that is before any economic recovery plan. And, of course, the increases in the debt will be even more. I believe when it is all said and done that we will probably add somewhere close to $2 trillion to the national debt this year alone.



In fact, we are building a wall of debt. Gross Federal debt is now estimated at $11.6 trillion by the end of 2009, and if we add in current policies, such as extending tax cuts, the alternative minimum tax reform that must occur, and ongoing war costs, we could easily

see the debt rise to over $21 trillion by 2019. And that would amount to well over 90 percent of gross domestic product in that year.



Here are some of the major initiatives that are being considered that could further add to that debt: one, the economic recovery package—and, again, I want to acknowledge the necessity of doing that; two, additional tax cuts; three, health care reform; and, four, additional defense spending.

Our long-term debt outlook is even more daunting. Here is a chart from CBO's long-term budget outlook, which was released in December of 2007. It shows what will happen to Federal debt over the next 50 years. With the retirement of the baby-boom generation, rising health care costs, and the permanent extension of the President's tax cuts, Federal debt will climb to more than 400 percent of GDP by 2058. That is clearly, utterly unsustainable.

Our debt, in addition, is increasingly financed abroad. In 2008, 68 percent of the increase in publicly held debt was held by foreigners. This presents another risk factor for our economy. If at some time these foreign entities stopped buying U.S. debt, interest rates would have to increase in order to attract the capital necessary to float the boat.

Here are the top foreign holders of our U.S. debt as of earlier this year. We now owe China $653 billion; Japan, $586 billion; the United Kingdom, $360 billion; the so-called Caribbean banking centers, $220 billion; oil exporters, $188 billion; and on and on it goes.

I would like to remind everyone of a point made by the former GAO Comptroller, Mr. Walker, early last year. He said, and I quote: "I believe we have a five- to 10-year window of opportunity to demonstrate to our foreign lenders that we are going to get serious about this. Five to 10 years, and it is closing. And I think it is closer to five than to 10. Keep in mind, we are the largest debtor nation in the history of mankind, and it is getting worse, not better."

I would just indicate that about 2 weeks ago a major financial figure in this country called me and told me that he is concerned that while he strongly supports the need for an economic recovery package in the short run, if we fail to address these long-term imbalances, the currency could collapse. I hope that this hearing today can help us all better understand the risks that are being run and what we need to do to address them.

With that, I want to turn to my colleague, Senator Gregg, for his comments.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman, and thank you for gathering this exceptional panel to discuss this absolutely critical issue which you have focused on for a long time and which I wish more of our colleagues were focused on. It is really the fiscal tsunami that is going to overwhelm our capacity as a Nation to be prosperous.

I have one chart I want to put up, because our debt is going to be driven by a simple fact, which is spending. This chart reflects where spending is going under the present programs we have in place that are already on the books and on which the people who will benefit from them already depend. And that means that spending as a percent of gross national product would go up to almost 31 percent, which is sort of the corollary chart to the one that the Chairman showed on the debt. And that is just not sustainable either. The Federal Government has historically taken about 20 percent of the gross national product in spending. Maybe we can take a little bit more, but we sure cannot take 31 percent of the gross national product and spend it.

And so as we know around here, making the tough decisions is a little hard to do, especially when it comes to controlling spending. But that chart says unequivocally that, as Willie Sutton used to say, "That's where the money is." So we need to get that under control.

So I will be interested in the panel's thoughts on the debt issue, but I will also be interested in the panel's thoughts on whether or not that spending chart is what is driving the debt.

Thank you.

Chairman CONRAD. Thank you, Senator Gregg, and thank you for your leadership across a broad range of issues facing this country.

We are very fortunate to have somebody of Senator Gregg's experience and judgment helping us in this time of crisis. You know, I do not usually spend time commending members of the other party, but I do want to acknowledge Senator Gregg's leadership at this extraordinarily difficult time.

Senator GREGG. Well, the feeling is obviously mutual, Mr. Chairman. You have been the voice in the wilderness for a little while. That is probably because you went to school in New Hampshire.

[Laughter.]

Senator GREGG. But, hopefully, there will be people gathering around your voice.

Chairman CONRAD. Well, you and I together are trying.

Dr. Berner, we are delighted to have you. Dr. Berner is the Managing Director and co-head of Global Economics and the Chief U.S. Economist at Morgan Stanley. Again, thanks for being here, and please proceed.

STATEMENT OF RICHARD BERNER, PH.D., MANAGING DIRECTOR AND CHIEF U.S. ECONOMIST, MORGAN STANLEY

Mr. BERNER. Chairman Conrad, Ranking Member Gregg, and other members of the Committee, I am very pleased to be here. Thank you for inviting me to this hearing to discuss the debt outlook and its implications for policy.

As you noted, we are at a crossroads for America's economic challenges, both immediate and long term. Our short-term challenge is to end the recession and promote recovery. Our long-term challenges are to promote a responsible fiscal policy and to reform our entitlement and other programs so they are sustainable.

The tension between these short- and long-term challenges will play out in financial markets. Fiscal stimulus and other measures likely will require the Treasury to issue $4 trillion or more additional Federal debt. For now, investors are buying. Treasuries are safe, inflation is falling, private credit demand is weak, and the Fed may buy longer-term treasury debt.

Federal debt held by the public starts at a low level in relation to GDP, as you see in my first chart: only about 40 percent of GDP at the end of fiscal year 2008. But this is changing quickly. The debt-to-GDP ratio will rise toward 60 percent by fiscal year 2013. Barring action to fix our entitlement programs——

Chairman CONRAD. Dr. Berner, could I just stop you there?

Mr. BERNER. Sure.

Chairman CONRAD. Because I know those who might be watching this are wondering why did Senator Conrad talk about debt going to over 90 percent of GDP and you are talking about 60 percent of GDP, and we should just explain to those who are listening that I am talking about the gross debt of the United States; you are talking about the publicly held debt. And the difference simply is publicly held debt is precisely what it sounds like—debt held by the public. The gross debt of the United States includes the money that we owe the various trust funds, most notably the Social Security Trust Fund.

Thank you. I apologize for that interruption.

Mr. BERNER. Thank you for that, Senator.

Chairman CONRAD. I know people would be confused.

Mr. BERNER. Thank you for that, Mr. Chairman. Yes, the gross debt would be quite a bit larger. From a market perspective, my guess is that the Federal debt held by the public is very important, but looking at the gross debt is equally important.

Barring action to fix our entitlement programs, as you noted, that ratio that I alluded to earlier will jump to over 100 percent by fiscal year 2022. History shows that such a jump in debt may boost debt service at the expense of other needs and with not much to show for it. Indeed, the Japanese experience—and on this chart, you see the ratio of Japanese Government debt to their GDP—shows the danger of assuming that fiscal stimulus alone can solve a financial crisis. Until the Japanese authorities got it right after 10 years of building bridges to nowhere, their economy was mired in a lost decade.

At the same time, one measure of our creditworthiness already does show some deterioration. U.S. sovereign credit default swap spreads have widened to about 60 basis points, or six-tenths of a percent—that is the red line in this chart—from about 10 basis points last summer. Now, obviously, in comparison with other economies which are much less creditworthy than we are—we are still the gold standard in financial markets—the story is quite different. And the global financial crisis has contributed to the rise in all of these spreads. But this is something, I think, that bears watching. So the simple message is that you ignore global investors at your peril.

In contrast, the right policies to end the crisis and to address long-term needs will be a win-win. A growing economy will give us the resources to provide for future needs, and crafting an exit strategy from short-term stimulus and a credible road map for longer-term reform will reassure investors that we are on the right track.

To promote recovery, we must ensure we get the most bang from the buck, for every buck that we spend. I will talk about some key elements.

First, let us talk about recovery. It is critical to diagnose how we got into recession. Losses at banks, non-banks, and investors have eroded their capital and promoted the deepest credit crunch in our lifetimes. Think of this as the S&L crisis—a crisis of solvency times ten. My colleague Betsy Graseck estimates that baseline losses for the U.S. financial system, which you see on this chart, could eventually total $1.5 trillion and easily run to $1.9 trillion. This loss of capital to support good and bad loans has forced lenders to shrink

their balance sheets. The credit crunch has spread to the broader U.S. economy and beyond our borders.

As you see in the previous chart, the tightening of lending standards from the Federal Reserve survey over on the right-hand side of this chart reflecting those losses indicates the magnitude of this credit crunch, which is unprecedented. The upshot is likely to be the deepest recession in the post-war period.

Now, history suggests that financial crises take time to fix, and history also suggests that policies that go directly to the cause of the crisis are most effective. As you debate a new fiscal stimulus package, therefore, keep in mind that tax cuts and stepped-up infrastructure outlays, whatever their merits, do not get to the causes of this downturn. They mainly tackle its symptoms.

In my view, two critical ingredients are still missing from the policy menu: first, cleaning up the lenders' balance sheets; and, second, mitigating mortgage foreclosures. Lenders will start lending again when they feel secure about their balance sheets. Of course, we want to return to responsible—not reckless—lending. Likewise, mitigating foreclosures is necessary to stem the slide in home prices, slow credit losses, and reduce the pressure on household wealth.

The Fed, the FDIC, and the Treasury are taking important first steps to attack the credit crunch. The next step must be an aggressive effort to fix balance sheets. In my view, a good bank/bad bank solution is the most effective one. The bad bank is an entity or fund set up to liquidate segregated bad assets. Investors will see in the good bank a new, cleaner balance sheet, which has two key benefits. Clarity on asset quality is needed to attract private capital. That is what we need to restore the health of our financial system. A clear split will also enable the managers of the good and bad banks to focus exclusively on their respective businesses. This is like the Resolution Trust Corporation, the RTC, of the early 1990's.

The Troubled Asset Relief Program embraced those goals, but buying troubled assets really does not work. Pay too much and put taxpayers at risk. Pay too little and lenders will not participate. That dilemma should not bar action, but such a plan may take time to implement, especially with fiscal stimulus plans demanding our immediate attention. In that context, a halfway house that could help clarify the nature of the policy commitment and of the assets themselves might be a step forward. It would involve financing or warehousing the troubled assets separately from the financial institutions in a special purpose vehicle, or SPV, and I have some details on that in my testimony.

Foreclosures, in turn, are costly and disruptive. They threaten home prices and market functioning and, thus, weaken housing and the economy. The best options for relief are simple: act quickly and spread the pain broadly among borrowers, lenders, and taxpayers. I like Christopher Mayer's proposals for a modern Home Owners Loan Corporation combined with lower interest rates and changes in the securitization law, and an industry fund to reimburse services for expenses. Fed Chairman Bernanke urges realistic principal writedowns with loss-sharing arrangements. The FDIC's foreclosure mitigation process seems a reasonable standard in that regard. So those are two things that are missing.

What about getting the most bang for the buck? How should we do that? First, policies that directly address the cause of the financial crisis are likely to be most effective in fixing it. Second, I favor providing insurance backstops and financing facilities because they restore market functioning and enable policymakers to leverage the taxpayer moneys they put at risk. Finally, for traditional tools such as tax cuts or increased spending, I favor policies that will offer the most direct stimulus.

No single policy will fix the financial crisis. I have described some of the necessary ingredients. Note that balance sheet cleanup would vastly increase the potency of capital injections that we might get from the taxpayer as a potential stimulant.

Regarding financing facilities and insurance backstops, note that some approaches are more potent than others. Dollar for dollar, I believe that treasury contributions to capital in a structure like the TALF—or the Term Asset-backed Lending Facility—that the Fed has proposed and which will begin operation in a month or so, are far more potent than asset purchases because every dollar from the taxpayer goes to support $10 of assets. The municipal bond and commercial mortgage-backed securities market could benefit from such a structure.

Restoring insurance backstops that have long facilitated the functioning of financial markets could be especially helpful today. Like lenders, mortgage insurers have good and bad books of business. Cleaning up the bad book and recapitalizing the insurers to get back to providing mortgage insurance would be a potent tonic for mortgage securitization. Likewise, cleaning up the insurers of municipal bonds, many of them the same entities that ensure mortgages, would pay big dividends for that market whose troubles have further impaired the ability of strapped State and local governments to obtain financing.

Mr. Chairman, I believe that recently you suggested just such a proposal.

Last, traditional fiscal policy tools will be far more potent in the midst of a financial crisis if steps are taken to address the crisis itself. And I favor those options which would offer the most direct fiscal stimulus. Some of them might involve taxes, some of them would involve infrastructure spending, and some might involve grants to State and local governments, particularly FMAP or Medicaid relief. Some view those as less potent than others, but it seems to me that those are the decisions we have to make.

Mr. Chairman, thank you very much for your time, and I welcome your questions.

[The prepared statement of Mr. Berner follows:]

The Debt Outlook and Its Implications for Policy
Testimony of Richard Berner, Morgan Stanley
Senate Budget Committee
January 15, 2009

Mr. Chairman, Ranking Member Gregg, and other members of the Committee, my name is Richard Berner. I am Co-Head of Global Economics at Morgan Stanley in New York. Thank you for inviting me to this hearing to discuss the debt outlook and its implications for policy.

We are at a crossroads for America's economic challenges, both immediate and long term.

Our short-term challenge is to end the recession and promote recovery. All tools at our disposal will be needed. Among them:

- The traditional tools of fiscal stimulus and monetary policy to cushion the blow.
- More important, unconventional tools to clean up lenders' and household balance sheets and to help restore the functioning of financial markets.

Both of these are needed to end the credit crunch that is the root cause of this global downturn.

Our long-term challenges are to promote a sustainable fiscal policy and to reform our entitlement and other programs that represent long-term claims on our future resources.

There is clearly a tension between these short- and long-term challenges, and that conflict will play out in financial markets. Fiscal stimulus and other measures likely will require the Treasury to issue $4 trillion or more additional Federal debt. For now, investors are buying. The yields on nominal 10-year notes and 30-year bonds are at or close to record lows. Treasuries are safe, inflation is falling, private credit demand is weak, the Fed will keep short-term rates low and may buy longer-term Treasury debt until they are sure the economy is on firmer ground. Debt held by the public starts at a low level in relation to GDP — only 40.3% of GDP at the end of FY2008.

But this is changing quickly. The debt-GDP ratio will rise towards 60% by FY2013. Barring action to fix our entitlement programs, that ratio will jump over 100% by FY2022. History shows that such a jump in debt may boost debt service at the expense of other needs and with not much to show for it. Indeed the Japanese experience shows the danger of assuming that fiscal stimulus alone can solve a financial crisis. Until the Japanese authorities took the aggressive steps required to fix their crisis, their economy was mired in a lost decade. At the same time, one measure of our creditworthiness already shows some deterioration — US sovereign credit default swap (CDS) spreads have widened to about 60 bps (0.6%) from 10 bp last summer. So the message is that you ignore global investors at your peril.

Yet, I believe that using the right policies to end the crisis and addressing our long-term needs will be mutually supportive. Specifically, putting our economy back on track will give us the resources to provide for future needs. At the same time, crafting an exit strategy from short-term stimulus and a credible and specific roadmap for longer-term reform will yield near-term benefits. It will reassure investors that we're on the right track and free up private resources for long-term investment.

We all agree that to promote recovery, we must ensure we get the most bang for every buck we spend. I'll have some recommendations on how to do that.

And we all agree that a responsible fiscal policy requires fixing our entitlement programs. It also requires much more. I'll talk about key elements needed.

Putting the economy back on track

It's critical to diagnose how we got into recession. Losses at "leveraged lenders" — banks, nonbanks and other investors — have eroded their capital and promoted the deepest credit crunch in our lifetimes. Think of the S&L crisis — a crisis of solvency — ten times over. My colleague Betsy Graseck, Morgan Stanley's

large-cap bank analyst, estimates that "baseline" losses for the US financial system will eventually total $1.5 trillion and could easily run to $1.9 trillion. This loss of capital to support good and bad loans has forced lenders to shrink their balance sheets. The credit crunch has spread to the broader US economy and beyond our borders. The upshot will likely be the deepest recession in the postwar period.

History suggests that financial crises take time to fix, because they result in deep and prolonged declines in asset values, and thus deep recessions (see Carmen M Reinhart and Kenneth Rogoff, "The Aftermath of Financial Crises," January 3, 2009). Fed Chairman Bernanke this week said, "History demonstrates conclusively that a modern economy cannot grow if its financial system is not operating effectively." And as I read it, history also suggests that policies that go directly to the cause of the crisis are most effective.

As you debate the size and composition of a fiscal stimulus package, therefore, keep in mind that tax cuts and stepped-up infrastructure outlays, whatever their merits, don't get to the causes of this downturn. They mainly tackle its symptoms and can only cushion the blow.

In my view, two critical ingredients are still missing from the policy menu: Cleaning up lenders' balance sheets and mitigating mortgage foreclosures. Lenders will start lending again when they feel secure about their balance sheets. Balance sheet repair is necessary to attract private capital and end the credit crunch. Of course, we want a return of responsible, not reckless lending. Likewise, rising foreclosures worsen the imbalance between housing supply and demand. Mitigating foreclosures is necessary to stem the slide in home prices, slow credit losses, and reduce the pressure on household wealth.

The Fed, the FDIC and the Treasury have taken important first steps to attack the credit crunch but they are not enough. FDIC guarantees of lenders' debt stopped the run on the financial system that emerged with the shock from Lehman's bankruptcy. The Fed has also massively and "quantitatively," eased monetary policy, has deployed an array of financing facilities, and will soon implement another with great promise, the Term Asset-Backed Securities Loan Facility (TALF). Those steps have restored functionality to money markets that are critical for financing business and finance, though some are still on life support. The Fed's purchases of mortgages are lowering borrowing rates to historical lows, boosting housing affordability and enabling borrowers to refinance their mortgages. The next step must be an aggressive effort to fix balance sheets.

Good Bank/Bad Bank to clean up balance sheets

In my view, a "good bank/bad bank" solution is the most effective solution. The "bad bank" is an entity or fund set up to liquidate segregated bad assets; implementation requires a way to value the assets, capital (or a mechanism to absorb and share the losses), and funding. Investors will see in the "good bank" a new, cleaner balance sheet, which has two key benefits. Most important, clarity on asset quality is needed to attract private capital. A clear split between the good and bad assets will also enable the managers of the good and bad banks to focus exclusively on their respective businesses.

The TARP embraced those goals but foundered on how to value and purchase opaque assets. Pay too much and put taxpayers at risk; pay too little and lenders won't participate. That dilemma should not bar action. But such a plan may take time to implement, especially with fiscal stimulus plans demanding your immediate attention. In that context, a halfway house that could help clarify the nature of the policy commitment and of the assets themselves might be a step forward. It would involve financing or warehousing the troubled assets in a special purpose vehicle (SPV). This would go part of the way towards cleaning up balance sheets for both surviving and failing lenders.

Foreclosure Mitigation

Foreclosures are costly and disruptive, threaten home prices and market functioning, and thus weaken housing and the economy. But there are obstacles to improvement: Not all foreclosures can or should be prevented. Offering help to the 3 million borrowers who are in serious trouble will create moral hazard by attracting the 52 million who aren't. It is hard to segregate responsible borrowers and lenders from those who weren't. Poor underwriting has resulted in redefault rates of 50% or more for modified loans.

The best options for relief are simple, act quickly, and spread the pain broadly among borrowers, lenders, and taxpayers. Christopher Mayer and his collaborators at Columbia University propose a modern Homeowners' Loan Corporation that would share the cost of writedowns between lenders and taxpayers and give the latter a warrant on future home price appreciation; Mayer also proposes changes in securitization law and an industry fund to reimburse servicers for expenses. Fed Chairman Bernanke urges realistic principal writedowns with loss-sharing arrangements. The FDIC's foreclosure mitigation process seems a reasonable standard: Write down principal to achieve 38% debt-to-income; use TARP funds to guarantee refinanced loans; and use the IndyMac protocol to streamline the process.

This mix does not address all the obstacles, and will not assure success. But the alternatives are worse. The economic cost of further declines in home values would likely exceed the cost of mitigation. More ominously, letting foreclosures fester may erode the sanctity of the mortgage contract for an increasing number of borrowers, who will decide that making payments is optional. If many borrowers walk away from their houses and their obligations, losses to lenders will rise dramatically and the availability of credit will dry up.

Getting the Most Bang for the Buck

How should we think about getting the most bang for the buck from stimulus? First, policies that directly address the cause of the financial crisis are likely to be most effective in fixing it. Second, I favor providing insurance backstops and financing facilities, because they restore market functioning and enable policymakers to "leverage" the taxpayer monies they put at risk. Finally, for traditional tools such as tax cuts or increased spending, I favor policies that will offer the most direct stimulus.

No single policy will fix the crisis; I've described the necessary combination. It's worth emphasizing that balance sheet cleanup would vastly increase the potency of capital injections as a stimulant.

Regarding financing facilities and insurance backstops, note that some approaches are more potent than others. I favor the Fed's TALF structure; dollar for dollar, I believe that Treasury contributions to capital in such a structure are far more potent than asset purchases because every dollar from the taxpayer goes to support $10 of assets. In addition to the asset-backed securities (ABS) market, two other markets might be helped by such facilities — those for municipal bonds and commercial mortgage-backed securities.

Restoring two insurance backstops that have long facilitated the functioning of financial markets would be especially helpful today. Like lenders, mortgage insurers have good and bad books of business. Cleaning up the bad book and recapitalizing the insurers to get back to providing mortgage insurance would be a potent tonic for mortgage securitization. Likewise, cleaning up the insurers of municipal bonds — many of them the same entities that insure mortgages — would pay big dividends for that market, whose troubles have further impaired the ability of strapped state and local governments to obtain financing.

Last, traditional fiscal policy tools will be far more potent in the midst of a financial crisis if steps are taken to address the crisis itself. I favor two options: A payroll tax holiday or a sizeable cut in payroll taxes, and grants to state and local governments. For example, a six-month suspension of the payroll tax would inject $425 billion into the economy. It would provide a boost to discretionary spending for lower-income workers who have the highest propensity to spend. In addition, cutting payroll taxes would reduce the cost of labor for employers, which, in turn, should help to stem the pace of job loss and shore up profitability. Some view such cuts as a raid on Social Security, and others argue that their potency is small because half the cuts would accrue to businesses. On both counts, I disagree. Grants to state and local governments would forestall cuts in needed services, especially if they were aimed at boosting temporarily the share of Medicaid borne by the Federal government. There are obstacles: Such grants run the risk of rewarding less responsible governments at the expense of the prudent. And it is hard to assure that the monies freed up in state/local budgets would be spent effectively.

Principles for fiscal responsibility

Beyond embracing steps to reform health care and other long-term programs, I endorse fully several steps that will help us get back on the road to fiscal responsibility. By embracing them now, the inevitable sacrifices and tradeoffs among policies can be spread more broadly.

First, tell voters that we have a serious fiscal problem, and a limited time in which to fix it. Mr. Chairman, your recommendation with Senator Gregg for a bipartisan fiscal task force could be the platform for that process. Second, elevate the issue and make it tangible. Making sure we have resources for our children is concrete. Third, commit to realistic goals and a rough outline of the gameplan needed. Good policymaking involves setting priorities, evaluating options and making choices. Fourth, begin to reform the broken budget process. Work with the new Administration to break down compartmentalized decisionmaking that holds no one accountable. Fifth, be honest about the numbers. Sixth, reinstate the discipline of PAYGO. Seventh, be willing to put all options on the table. Finally, don't spend revenue windfalls or savings from budgeted programs.

Mr. Chairman and members of the Committee, we proved in the 1990s that these principles can turn the budget around. We can do it again. Otherwise, as in the 1980s and early 1990s, financial markets may again impose discipline on the political process and force you to make much harder choices than the ones you face today.

Chairman CONRAD. Thank you, Dr. Berner. Thank you for your thoughtful testimony.

Dr. Allen Sinai is the Chief Global Economist and President of Decision Economics, someone who has appeared before this Committee in the past, and we always appreciate his insights. Welcome, Dr. Sinai.

STATEMENT OF ALLEN SINAI, PH.D. PRESIDENT AND CHIEF GLOBAL ECONOMIST/STRATEGIST, DECISION ECONOMICS, INC.

Mr. SINAI. Thank you very much, Mr. Chairman. There is a long testimony which will be in the record. I am going to depart from that and focus on the questions you posed at the beginning. I may weave some of the material of the testimony into that.

You asked three questions. Let me preface, before I answer or attempt to answer those—the creditworthiness of the U.S. Government, the future of that; tipping point; deflating of the debt bubble—with just a few words about the current state of the U.S. and global economies. We have had, I think, a long previous global economic and financial boom that was characterized by commodity, real estate, financial asset price bubbles, booms and bubbles, imbalances, long-time imbalances and excesses, in the U.S. particularly on the consumer side and the financial side. And that is now all unwinding. These things do not go on forever.

You mentioned tipping point. We have a series of tipping points that we have exceeded now, and we see it in the abrupt, sudden, sharp, stunning declines in economic activity, not just in the U.S. but in the euro zone and Japan, and, with respect to global output, over 90 percent of global output. And this is a boom, bust, bubble-bursting episode that transcends anything that has gone on post-1930's. It is a unique business cycle situation, and that is why it scares so many of us. We have not seen it before to this extent. And I think that is why we have seen the Federal Reserve and the Federal Government take unprecedented steps and put the U.S. Treasury at risk in the way that it has by attempting to support the financial system and credit—that is, the Federal Reserve and to some extent the Treasury—and the other measures that treasury has taken with regard to this. As a result, our budget is extremely exposed, and we still need more help.

The outlook for 2009 is—ex an Economic Recovery Program because we do not exactly what that is going to be yet—real GDP down about 2, 2.1 percent on an annual basis. That is close to the decline, projected by CBO. We are in the heart of decline now. The economic news is the ugliest it will be, particularly the jobs count. And outside the United States, for the 47-country global aggregate that we monitor and forecast, we are projecting global growth to be down half a percent. On our records, which go back to 1980, we have never seen that. So the global dimension of this is notable. That feeds back, hurts U.S. exports, and prolongs this downturn. It is likely to be the longest, almost already is—at best, 20 months; at worst 27 or 28 months. And with Dick Berner I would agree; it is going to end up as the deepest peak to trough since the 1930's.

Now, the creditworthiness of the U.S. Government in this situation—Is it at risk? you asked. Yes, unequivocally yes. We do not see that now because the rest of the world is going through quite a bit of turmoil, and the U.S. is the gold standard. It is a safe haven. The dollar is a safe haven. And all investors are fleeing to quality. Financial institutions are essentially holding the treasury securities that they obtained for purposes of survival and capital requirements. There is a huge demand for treasuries, and we have yet to see the onslaught of the huge volume of treasury financing

that is going to come, on deficit projections that we have for this year, without stimulus, $1.4 trillion in fiscal year 2009 and $1.1 trillion or $1.2 trillion next year. I think that exceeds the CBO estimates. There is a big cyclical element in that, but all the other, the Government support, TARP, all of that is in those numbers.

If you add on to that an $800 billion—$400 billion a year—Economic Recovery Plan, we would say the deficit this next fiscal year would be closer to $1.8 trillion and $1.4 trillion next year. And beyond that, not much different as things now stand from $1 trillion plus a year all the way out to 2018.

By the way, in Table 11, on page 39 of this very long testimony, we did produce for you our deficit projections without an Economic Recovery Plan prospect, and the gross Federal debt that is the concept as you defined it, Mr. Chairman, gross debt held by the public as a percent of GDP. Without an Economic Recovery Program, we would be 7 or 8 years from now at about 90 percent. If we add on an Economic Recovery Plan of about $800 billion and the implications of that further on for infrastructure under current law, we would project over a 100 percent gross debt-to-GDP return by 2016. That gets us into World War II gross debt-to-GDP figures.

There is no way to think that the creditworthiness of the U.S. Government is not at risk and at stake on projections, in the best of circumstances, that give us these kinds of Federal Government debt ratios. There is just no way to think that the creditworthiness of our country is not at stake. When we see a central bank using its balance sheet, the way the Federal Reserve has, there probably is no other choice and I am supportive of what is going on—the balance sheet of the Federal Reserve is highly exposed, and it is part of the Government. And so, yes, emphatically yes. It does not solve the problem, but the answer to your first question is yes.

As for a tipping point, this is very difficult. Some years ago, as a junior author with Robert Rubin and Peter Orszag, we wrote a paper about financial and economic disarray in terms of the exposure of the U.S. on the deficits, international and Federal Government, and the private sector debt accumulation, particularly in the consumer sector, at that time fledgling exposure in the housing sector, and talked about in that paper how it could be devastating. But we could not say when.

Well, we have arrived at that point now, 4 years after we wrote that paper in 2004. I kidded Mr. Rubin at that point. I said, "Don't make that a near-term forecast because systems have a way of avoiding this for a long time. But eventually it will happen."

I think what we see now worldwide is, in part, that financial and economic disarray, particularly focused around the consumer whose excesses in real estate, fed by the financial system, got us to a situation where now the American consumer is facing a seismic shift in the conditions around consumption, which sets the growth path for the United States on an anemic plane for years now. I think Americans understand that. There is not money now to spend and borrow, accumulate debt, the way we have done for so many years, and even decades. It just is not there. Consumption that is 70 percent of the economy.

So a tipping point with regard to the debt and deficit ratios and the forward look at these kinds of fiscal exposures is tough to call.

But I think when we get through this downcycle and do all that we are going to do worldwide to get us out of it—lots of actions outside the United States, not just in the United States—then the U.S. will be extremely exposed, relatively speaking, to the financial markets, and particularly our treasury market will be exposed, the dollar would be exposed. And that is where you would see it first, in the financial markets, our currency not favored, no longer a safe haven, as it is now; no longer a flight to treasuries, a flood of treasuries instead, with the only buyers for those treasuries, relatively speaking, us. And probably one of the biggest buyers will have to be the Federal Reserve, whose proportion of treasuries in its portfolio now is very low. So they can buy treasuries and buy treasuries and buy treasuries. And I think they are going to do that as part of their American-style quantitative easing.

But down the road, if it turns out that the Federal Reserve is the only buyer of a flood and huge volume of treasury financing coming from the United States, long-term treasury yields will skyrocket and the dollar will plummet. That will reverberate, take down our stock market, and of that kind of financial distress will reverberate back to our economy and diminish the standard of living of Americans as far as the eye can see.

I do not know when because we do not know when all of this current trouble is going to resolve. We do have time. And in the policies that are set in discussion of an economic recovery program, it will be very important to look down the road and not just pay lip service in terms of getting the deficits and debt under control far out, but to actually think about that in the deliberations mechanisms by which you can set those deficits and debt-to-GDP ratios in a different direction. Today, I do not have the answers on how to do that.

PAYGO, which was one answer before, is an option. It is a little hard to apply PAYGO near term if we think the economy may go down 2 percent in 2009. You do not want to apply PAYGO at a time when the economy is spiraling down. But long run, something like revisiting and reinstalling PAYGO is one possible option. Others have to do with bigger issues. Health care and the costs of health care, a major drawdown of our financial resources, resolving, as Dick talked about, the financial system problems, which is draining our treasury. What we do about energy—these are huge issues. They are hugely levered for the U.S. economy and the budget of the United States and not easy to tackle.

Finally, deflation and a debt bubble, your third, the answer to your question on tipping point. It will happen if we do not do anything and build into the plans that we are now dealing with for bringing our economy back and our financial system back. If we do not now build in mechanisms to shift that out-year prospect in advance, we will regret it immensely, and the tipping point will come.

We have a debt bubble deflating now. The issue is: Are we going to get a deflationary spiral and a debt deflation 1930's-like process? Our odds on that are about 15 or 20 percent; that is to say, we are now going to go through, we think, 3 to 6 months of deflation. It is not what we mean by the deflation that involves the deflationary spiral and a debt deflation process. But one of the early signs is that there is a near zero interest rate with inflation expectations

declining, raising real rates, already showing up. Debt deflation, a deflationary spiral, further deflation of a debt bubble that has burst and is coming down, signs of consumers taking down debt finally, would put us into a 1930's—I would not say we will have another Great Depression, but it would be the modern-day counterpart to that.

That is a risk we are monitoring. We are quite nervous about it. Best odds are that the stimulus of the Federal Reserve and other central banks around the world and the fiscal stimulus, economic recovery program stimulus of the United States and from around the world, will keep us out of a deflationary spiral, but I could not say that with the degree of certainty that I would want to. In such a situation, which is probably the thrust of your question, the burden of the debt of the United States would be even more onerous if the dollar went through a major decline on our financial fragility at the Government level. That, too, would be punishing with regard to the debt.

The bright spot is at the same time that the Federal Government debt is rising and deficits are rising, the U.S. private sector will save more, particularly households, and you will get some offset. The personal savings rate will very likely go up to 5, 6, maybe even 8 percent as we return to a more normal situation with the consumer. The mirror image of it is very anemic consumer spending and a very weak economy.

Thank you very much.

[The prepared statement of Mr. Sinai follows:]

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Economic and Financial Crises, Policy Responses, Deficits and Debt, and Possible Actions

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Remarks presented in testimony at a Senate Budget Committee Hearing, "The Debt Outlook and Its Implications for Policy," U.S. Senate, Dirksen Senate Office Building, Thursday, January 15, 2009.

Economic and Financial Crises, Policy Responses, Deficits and Debt, and Possible Actions

by Allen Sinai*

After a long U.S. and global economic and financial boom characterized by commodity, real estate and financial asset price bubbles, imbalances and excesses, the U.S. economy has fallen into a pronounced recession—probably to be the longest and perhaps deepest since the 1930s. The global economy is in a substantial recession as well; also deep and probably long, likely the worst in modern times. Along with the U.S. and global recessions, now arguably an *economic crisis* in breadth, abruptness, and the potential for even worse; there is a *financial crisis*.

In the U.S., there has been a collapse in credit and in financial intermediation within and outside the financial system, an associated failure fallout of financial institutions and companies, and apparently with no other choices more involvement in the private sector by the federal government and Federal Reserve than any time in modern history.

As a result, the federal budget deficit and public debt, however measured, are soaring, in absolute levels and relative to nominal GDP, which is shrinking. The increases in deficits and debt, some cyclical, some structural, raise numerous questions about the ability of the United States to afford all the initiatives, including economic, queued up for action in the aftermath of years of neglect and whether there is a point at which the creditworthiness of the United States Government could lead to further financial and economic disarray and an even more diminished standard-of-living prospect for the country. The striking rises in federal budget deficits and government debt most certainly cannot be benign, nor ignored and, at some point, along with measures taken to revive the U.S. economy and stabilize the financial system, must be confronted in terms of actions designed to arrest and reverse the now most likely path of financial fragility for the U.S. Government.

Events and conditions, the data U.S. and worldwide, sudden and sharp declines in real economic activity, and substantial interventions by government and central banks suggest more than just the effects of a housing boom, bubble, subprime mortgage bust, and ordinary recession. The sweeping nature of the U.S. and global economic downturns, financial disarray, contractions and writedowns in the balance sheets of financial institutions, severe bear equity markets, instability of financial markets generally, massive losses of wealth, and now near-zero or very low short-term interest rates set by many central banks speak to the presence of broader and

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deeper negative cyclical processes than heretofore seen; perhaps to be compared with the 1930s for the U.S. and Japan in the 1990s.

What are the policy responses, macroeconomic specifically, in such a time of crises? What could be the macroeconomic effects on the U.S. economy of some policy alternatives—monetary and fiscal? What might be the macroeconomic and budgetary effects of any New Economic Recovery Program that might be proposed and legislated? What about the deficits and debt at the federal government level resulting from the crises and the policy actions to deal with them? What actions could be considered to mitigate the deficits and debt that will arise from government spending and tax cut stimulus?

In this testimony is presented the current state-of-play of the U.S. and global economies, with a gloomy assessment of the current situation, short- and longer-term, and considerable risks of something worse especially *if no major new policy actions are taken.* The testimony presents the potential effects for some macroeconomic policies through simulations with a large-scale macroeconometric model of the U.S. economy—the Sinai-Boston (SB) Model. It discusses the role of monetary policy, necessarily and typically in U.S. business cycles defining for dealing with downturns, but argues that this is not so currently. In a situation of inadequate aggregate demand and relatively impotent monetary policy, "Keynesian-like" fiscal stimulus, and not just increases in federal government spending, would seem to be indicated; however, causing increased federal budget deficits, large rises in U.S. Government debt, and heavy involvement of the federal government in the private sector as probable side effects.

The fiscal alternatives examined include a possible Obama Administration Economic Recovery Program, near $750 billion of aggregate demand stimulus from large increases of federal government outlays and sizeable tax reductions. The deficits and debt implications on such a program also are presented.

Some summary perspectives—

1) *the monetary policy of low interest rates and now "American-style quantitative easing" should be continued and enhanced,* with the Federal Reserve in the financial and economic crises acting as lender-of-last-resort to the *private sector*, not just performing its more traditional role of supporting the economy as a lender-of-last-resort to banks and the credit channel. That channel is severed, with numerous financial intermediaries ranging from banks to investment banking/brokerage firms to insurance companies and the financial arms of nonfinancial corporations who have been performing the traditional functions of bank lending and investing no longer able or willing to do so. Moral hazard and potentially higher inflation longer-run do

present possible problems on such Fed actions, but the downside prospect on the economy and jobs and financial instability considerably outweigh these, at this time.

2) *a fiscal stimulus consisting of large increases in federal government outlays and reductions in taxes is needed* to lift an extremely depressed and weak U.S. economy, but it must be noted that the side effects of such actions might later produce significant negative feedback effects. A big stimulus is not necessarily the best. The bigger the stimulus the less are the additional net gains, with larger stimulus programs raising inflation, long-term interest rates, and the dollar to diminish the effects. There are diminishing returns to larger program sizing.

3) *between increased government outlays and tax reductions, a 50-50 mixture of the two is about optimal.* Federal government purchases have a strong and sharp impact on the economy initially, with the purchases impact multiplier for the first year estimated in a range of 1.4 to 1.8, and can significantly increase employment in the government sector. But this stimulus is not lasting as feedback effects on interest rates, inflation, the dollar and stock adjustments operate to return the level of the economy to its original path within six or seven years. Tax reductions for individuals, permanent not temporary nor targeted tax credits, take longer to have an impact but produce a longer-lasting path of real GDP that exceeds what otherwise would have occurred and more broadly-based jobs increases. The savings out of the tax reductions are used to replenish and reliquefy household balance sheets, initially slowing down the pace of spending but speeding the financial adjustments of households to a more normal state which then supports higher spending for a longer period of time.

4) *a by-product for the longer-run from the current crises and the coming policies to combat it is record-high federal budget deficit/GDP and debt-to-GDP ratios*, unprecedented in peacetime, and potentially a significant negative for the dollar, interest rates, the U.S. stock market, inflation, the economy and the U.S. standard-of-living. How much deficits, how high debt-to-GDP, and when the point of financial disarray and negative economic effects might occur is not knowable—but, for sure, someday it will.

There is no easy way out of the current situation of financial and economic disarray nor any quick policy fix from any source that does not have significant potential negative side effects, challenges, and questions having to do with the aftermath.

State-of-Play—Worst Downturn Since the 1930s?

The U.S. economy is in at least a "Long-and-Deep" recession, centered now around a secular and intensely cyclical downturn in the growth of aggregate consumption and a significant upturn in personal saving.

This is a big deal since aggregate consumption has been as high as 71-1/2% of real GDP, is now down to 70%, and likely to keep declining toward the more normal but still quite large 67% ratio in-place for many past years. Residential construction, which led the U.S. downturn, now is only 3% of real GDP; it was about 5-1/2% three years ago. Years of aggressively strong consumer spending, borrowing on easy credit, and debt accumulation secured by rising values of real estate and equities seem to have come to an end and abruptly so.

All the major fundamentals surrounding the consumer are negative—

1) jobs and disposable income—huge jobs losses, 1.531 million in nonfarm payrolls over October-to-December 2008, a rapidly rising unemployment rate, and real disposable income up only 1.6% over the past year to November;

2) deteriorated household balance sheets—real household wealth down an estimated $10 trillion over the past year and likely to decline another $5 trillion to $8 trillion this year;

3) consumer confidence—currently at deep recession levels regardless of the measure;

4) housing equity financing—no longer available to tap nor any more the aggressive lending practices that helped propel home prices and household wealth to levels generating large amounts of cashout financing, capital gains realizations, and the increased wealth that raised consumption and drove the personal savings rate negative;

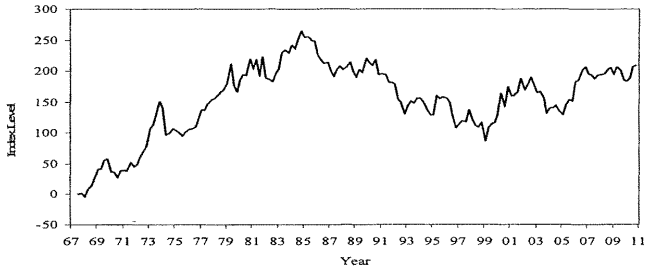
5) a credit crunch—especially for weak credits but also strong ones, liquidity and credit restraint on spending as financial institutions and nonbank financial intermediaries cut back on loans and investments to preserve capital and investors withhold funds from the capital markets;

6) deteriorated household sector balance sheets—the worst household sector financial conditions since the early 1980s as measured by the DE Household Financial Conditions Index (Chart 1) and likely to worsen further.

No help is in sight any time soon for the consumer. Large declines in crude oil, gasoline prices and commodities prices from boom and bubble peaks are helping to increase real purchasing stimulus and do provide a bright spot. But the potential $200 to $300 billion of additional consumer spending that might be estimated from the $100+ decline of crude oil prices in recent months will be more-than-offset by the negative effects of the $10 trillion decline in household net worth (about $600 billion of lost consumption over the next year at a DE-estimated propensity-to-consume of $0.06 on a dollar of lost wealth) and the weakening of consumption associated with only a 1%-to-2% rise in real disposable income.

Consumers cannot get any more funding, anywhere, from any outside sources as was possible for much of the last decade. *There is no other choice but to save more out of income.*

Chart 1
The DE Household Financial Conditions Index*



Source: Decision Economics, Inc. (DE).
*High values indicate more negative household financial conditions; low values more positive financial conditions.

This is a Seismic Shift, a change in secular trend that suggests much less growth in real consumption for some time than the average 3-1/2% growth per annum over the past 45 years. In the current cyclical downturn, outright declines in consumption are occurring, the likes of which have not been seen post-W.W.II. *At about two-thirds of real GDP or more, the path of consumption conditions the path of real GDP.*

The depressed consumer spending has a number of negative implications.

First, it means continued weak demand for big-ticket items such as houses and autos, and other categories of discretionary spending, also consumer caution which will show up as bargain-hunting, and radiates out broadly to depress business sales and profits and the exports of non-U.S. countries.

Second, weakened actual and expected growth in business sales and profits are bringing cutbacks in production, inventories, employment, capital expenditures and entrepreneurial activity, as well as imports.

As businesses hurry to reduce costs, jobs losses have been accelerating—almost 2.6 million net lost jobs, on the nonfarm payroll basis, over 2008 and substantial increases in part-time employees and in discouraged workers. The unemployment rate jumped in 2008, rising from 5% in December 2007 to 7.2% this past December. Industrial production has declined sharply, especially in recent months, and is estimated to be down 6.7% over a year ago. The various regional and national Purchasing Managers' Survey Indexes of economic activity have reached new low levels. A downturn in business capital spending has begun, following, as is typical, the

recession in housing and weakness in consumption. The capital spending downcycle usually lasts a year-or-so.

Third, U.S. imports are rising more slowly and some have been declining since most relate to consumption and business outlays. But those imports are other countries' exports so declines in the exports of major export-driven economies such as China, Mexico, South Korea, Hong Kong, Japan, Canada, parts of the Eurozone, Russia, and the other oil-producing countries of the world are weakening those economies that have tight and extensive trade ties with each other, such as in Asia.

Although almost all countries except China are less exposed on exports to the United States as a percent of the total than previously, the huge declines in U.S. consumption and now in capital spending have levered down exports and trade around-the-world, contributing significantly to the global recession.[1] In turn, with lags, U.S. exports are reacting. Nominal exports are down for three consecutive months and real export growth is slowing.

Finally, the beleaguered consumer and deteriorated household sector finances suggest worsening consumer credit and additional problems for lenders, banks and the financial arms of companies that sell consumer products, e.g., GMAC and GE Credit, on potential credit losses.

Still ongoing is the downturn in housing. Excess supplies relative to demands continue to depress new and existing home sales, housing starts, homebuilding and residential real estate. Housing prices likely will keep falling as a result, taking down household wealth, consumer spending, and the asset values and balance sheets of those financial institutions that hold mortgage-related investments and debt.

Table 1 shows the main features of the U.S. economic forecast, a Baseline, *assuming no major new changes in macroeconomic policies* other than what is already embodied in law and in the current policy of the Federal Reserve. This will change since it is clear that the Obama Administration and Congress will propose and pass some sort of Economic Recovery Program. And, so will the Baseline, not really a forecast until the Obama Administration and Congressional fiscal stimulus take shape.

Without any significantly stimulative new macroeconomic policies, the U.S. economy is expected to suffer *at least* a "Long and Deep" recession lasting anywhere from 20 months to 27 or 28 months and the deepest decline in real GDP since 1947, on an annual basis, -2.1%. Even with a stimulus program, a result close to the Baseline, or worse, could occur.

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[1] See data on country export exposures over selected time periods in Sinai (2007, pp. 300-303) or in the *DE Economic Studies Series #63*, pp. 18-19.

Table 1
Decision Economics, Inc. (DE) Baseline—"Long and Deep" Downturn*
(Qtrly. and Annual Averages Unless Otherwise Indicated)

	Quarterly (As of January 2009)					Annual			
	2008:4F	2009:1F	2009:2F	2009:3F	2009:4F	2007A	2008F	2009F	2010F
Economy									
Real GDP (% Chg.)	-4.9	-4.7	-2.1	1.5	1.9	2.0	1.2	-2.1	1.9
Consumption (% Chg.)	-2.7	-2.6	-1.2	1.4	1.9	2.8	0.3	-1.5	2.1
Business Fixed Investment (% Chg.)	-13.3	-13.7	-8.0	-1.5	0.8	4.9	2.1	-8.2	3.0
Res. Construct. ($'00 Bils.)	332.9	304.9	296.7	293.5	295.7	453.8	359.8	297.7	317.0
Net Exports ($'00 Bils.)	-350.5	-360.7	-362.7	-355.5	-360.5	-546.5	-386.7	-359.9	-350.5
Govt.									
Federal (% Chg.)	0.2	2.7	2.4	2.9	3.0	1.8	5.5	3.8	2.4
State and Local (% Chg.)	0.4	0.8	1.1	1.5	1.1	2.3	1.3	1.0	1.3
Personal Savings Rate (%)	2.8	4.1	5.0	5.7	6.4	0.6	1.7	5.3	5.8
Inflation and Unemployment									
Consumption Price Deflator (% Chg.)	-5.7	-2.2	1.8	2.0	2.1	2.6	3.3	-0.1	2.1
Consumption Deflator Ex-Food & Energy (% Chg.)	0.6	1.8	1.5	1.8	2.1	2.2	2.2	1.6	2.1
Unemployment Rate (%)	6.7	7.3	7.7	8.1	8.6	4.8	5.8	7.8	8.2
Jobs									
Nonfarm Payroll (Mils.) (1)	-1.531	-1.227	-0.975	-0.810	0.323	1.096	-2.589	-2.647	1.061
Civilian (Mils.) (1)	-1.751	-1.310	-1.105	-0.950	0.511	0.262	-2.956	-2.529	0.929
Fed. Bdgt. Def./Surplus (Unified, Fiscal Yrs., $ Bils.)	--	--	--	--	--	-179.3	-463.1	-1408.2	-1167.0
Fed. Bdgt. Def./GDP (%)	--	--	--	--	--	-1.3	-3.2	-9.8	-7.8
Debt-to-GDP (%)	74.3	77.7	80.2	82.3	84.1	65.0	67.7	81.0	87.1
Interest Rates (%)									
Federal Funds	0.37	0.14	0.22	0.36	0.45	4.93	1.75	0.30	1.27
3 Mo. T-Bill	0.27	0.07	0.21	0.31	0.40	4.46	1.36	0.25	1.33
10-Yr. U.S. Treas.	3.22	2.19	2.28	2.35	2.52	4.63	3.82	2.34	3.46
Corp. AAA-Equiv.	3.69	2.62	2.79	2.95	3.09	5.86	4.26	2.88	4.15

*Source: Decision Economics, Inc. (DE). *These projections assume no new major policy changes.* The Baseline has current policies—monetary and fiscal, the latter as reflected in current law. The monetary assumption is "quantitative easing" during 2009 and small, gradual increases in the federal funds rate throughout 2010.

F-Forecast

A-Actual

(1) Qtr.-end to Qtr.-end for Quarters and December-over-December for Years.

Table 2
Global Economic View
Real Economic Growth (1)
(Percent Change)

	2007	2008**	2009**	2010**
United States *	**2.8**	**2.0**	**1.2**	**-1.9**
Canada *	**2.7**	**0.6**	**-0.8**	**2.1**
United Kingdom *	**3.0**	**0.6**	**-2.5**	**1.0**
Europe	**2.6**	**0.7**	**-1.8**	**1.3**
France *	2.1	0.7	-1.7	1.4
Germany *	2.6	1.0	-2.5	1.3
Italy *	1.4	-0.7	-2.0	1.1
Switzerland *	3.3	1.8	-0.6	1.3
Asia-Pacific	**2.7**	**0.3**	**-1.9**	**1.3**
Japan *	2.4	0.0	-2.3	1.1
Australia *	4.2	1.6	-0.2	2.0
New Zealand *	3.0	0.2	-0.4	1.8
Newly Industrialized Countries	**5.6**	**3.1**	**-0.8**	**2.8**
Korea *	5.0	4.1	-0.9	3.1
Taiwan	5.7	1.3	-1.5	2.1
Hong Kong	6.3	2.5	1.4	1.9
Singapore	7.7	2.2	-1.2	3.6
Latin America	**5.2**	**4.3**	**1.8**	**3.2**
Argentina	8.7	6.2	2.8	3.7
Brazil	5.4	5.3	2.9	4.3
Mexico *	3.3	2.0	-0.5	1.5
Venezuela	8.4	5.7	3.2	3.5
Chile	5.2	3.6	2.3	3.1
World	**3.8**	**2.2**	**-0.4**	**2.5**
OECD	**2.6**	**1.0**	**-1.6**	**1.9**
EU	**2.8**	**0.8**	**-1.7**	**1.3**
Eurozone	**2.6**	**0.7**	**-1.8**	**1.2**
Asia-NICs, Emerging	**9.0**	**7.0**	**4.7**	**5.5**

	2007	2008**	2009**	2010**
Europe				
Spain *	3.7	1.0	-2.3	1.0
Portugal *	1.8	0.6	-0.3	1.7
Netherlands *	3.5	1.0	-1.3	1.3
Belgium *	2.6	1.2	-1.0	1.4
Austria *	3.0	1.4	0.1	1.4
Greece *	4.0	3.0	1.5	1.7
Ireland *	6.0	-1.8	-1.3	2.0
Scandinavia	**3.0**	**1.2**	**0.1**	**1.5**
Denmark *	2.0	-0.7	-1.2	1.5
Sweden *	2.7	0.4	-1.1	1.4
Norway *	3.2	2.4	0.9	1.5
Finland *	4.4	3.0	2.5	1.5
Eastern Europe	**5.2**	**3.8**	**1.6**	**3.3**
Poland *	6.7	4.9	2.7	3.6
Hungary *	1.3	1.7	-1.8	1.3
Czech Republic *	6.6	4.1	1.8	3.2
Turkey *	4.6	3.5	1.5	3.5
Russia	**8.1**	**7.1**	**3.9**	**5.2**
Emerging Asia	**10.1**	**8.2**	**6.4**	**6.4**
China	11.8	9.0	7.6	7.0
India	9.0	8.5	6.3	6.8
Indonesia	6.3	5.9	3.5	4.0
Malaysia	6.3	5.5	1.7	3.9
Philippines	7.2	4.8	2.9	3.7
Thailand	4.9	4.5	2.7	3.7
Middle East	**5.5**	**4.9**	**4.3**	**4.7**
Israel	5.4	3.4	3.7	4.0
Egypt	5.5	5.3	4.4	4.9
Jordan	6.0	5.9	4.9	5.2
South Africa	**5.1**	**4.8**	**1.9**	**3.0**

(1) Real GDP
*OECD countries
**Forecast

Table 3
Postwar Recessions: How Long and How Deep?

	Peak	Trough	Length (Mos.)	Peak-to-Trough Pct. Chg. in Real GDP
1.	Nov. 1948	Oct. 1949	11	-1.69
2.	Jul. 1953	May 1954	10	-2.65
3.	Aug. 1957	Apr. 1958	8	-3.18
4.	Apr. 1960	Feb. 1961	10	-0.54
5.	Dec. 1969	Nov. 1970	11	-0.17
6.	Nov. 1973	Mar. 1975	16	-3.10
7.	Jan. 1980	Jul. 1980	6	-2.18
8.	Jul. 1981	Nov. 1982	16	-2.63
9.	Jul. 1990	Mar. 1991	8	-1.26
10.	Mar. 2001	Nov. 2001	8	0.35*
11.	Dec. 2007	?	20-to-27F	-3.10F
	Avg. Length/Depth (1)		10.4	-1.71
	Median Length/Depth (1)		10.0	-1.94

*Two of three quarters negative, not consecutively so.
F-Forecast
(1) Not including estimated or forecasted current episode.

The current downturn is shaping up to be the longest since W.W.II for many reasons.

First, it is already in its 14th month, dated recently by the National Bureau of Economic Research (NBER). The criteria used relied mostly, and correctly, on monthly economic indicators, all of which have moved well below previous peaks despite positive growth in real GDP over the first two quarters of 2008. Until recently, the recession could be called mild on these indicators, but turned down sharply in late summer, intensified by the credit crunch and financial disarray.

Second, the recession is now consumer-driven and will stay this way because of numerous negative short-term and long-run fundamentals surrounding the consumer; most particularly, a liquidity- and credit-constrained consumer reflecting many years of excessive spending, reliance on credit and debt, overbuying of big-ticket and other items, and dissaving. The brunt of the consumer downturn is only now unfolding. A long period of adjustment would seem necessary to eliminate the imbalances reflected in Chart 1 above.

Third, the housing downturn, or bust, still has considerable time to run. Housing prices continue to decline on excess supply relative to shrinking demand. Failure fallout of home foreclosures and bankruptcies is holding up the supply of housing. The lack of liquidity and credit for home purchases in the face of declining housing values is taking down demand. Bootstrap equity financing from rising values of real estate is no longer possible. There is also the changing psychology of price expectations that will deter this particular discretionary

purchase. Similar considerations apply to motor vehicle sales, now down almost 50% from a year ago and probably to stay low for quite some time.

Fourth, the capital spending downturn has just begun, mainly in response to the weakened sales and profits of the housing and consumer downturns. Historically, a capital spending downcycle lasts about a year with amplitude considerably greater than the swings in overall consumer spending.

Then, there is developing weakness in U.S. exports off the global recession as the unusually severe global recession negatively affects U.S. trade.

Finally, although a massive easing of monetary policy has occurred and a large fiscal stimulus program can be expected, the lags in effects from the stimuli can be very long, especially if in the process credit is tight, asset deflation is occurring, and potentially a debt deflation.

As for the depth, the Baseline has a 3.1% decline in real GDP, peak-to-trough, about as deep as the previously deepest post-W.W.II recession of 1957-58, which was -3.2% peak-to-trough. In the recessions of 1973-75 and 1981-82, 16 months each in length and each the longest since the 1930s, peak-to-trough declines of -3.1% and -2.6% in real GDP were recorded, respectively.

However, real GDP might not be the best measure for the depth of a recession given the changing structure of the U.S. economy. The bust in housing, depression in the financial sector, consumption spending downturn, coming recession in capital spending, and losses of jobs may be more indicative of depth than the GDP summary measure, which tends to be resilient probably because of the very large services sector in the U.S. economy.[2]

Inflation and unemployment are behaving as might be expected, moving inversely to one another, sharply so recently, and are expected to continue this way with so much developing slack in product and labor markets. Much higher unemployment rates can be expected on so much economic weakness. Downward pressure on prices and wage compensation likely will bring sharp reductions in overall inflation rates.

Over the past year, the unemployment rate has risen from 5% to 7.2%, overall CPI-U inflation has dropped from a high of 5-1/2% in July, year-over-year, to an expected essentially flat reading in December. Ex-Food and Energy less of a decline has occurred, from 2.6% in

[2] An example is Health Care, which has been a booming sector in the U.S. economy and now accounts for a much greater proportion of GDP and of consumption spending than ever before. Medical Care outlays are nearly 16.7% of total consumption as against 14.3% for consumer spending on all durable goods. Given the nature of this sector, the demands of an aging population, a drive to insure all Americans and the increased size of health care in the economy, real GDP is supported despite the sizeable declines in economic indicators such as industrial production that used to depict well the overall economy.

August, year-over-year, to an estimated 1.8% in December, in the 1%-to-2% range that for most members of the Federal Reserve is viewed as price stability. Capacity utilization in the U.S. has declined from 81% a year ago to an estimated 75% in December.

Outright deflation has occurred in commodity prices, where another price bubble appears to have burst, in crude oil particularly, also on a near-term basis in the overall PPI and CPI-U. Whether the deflation lasts or evolves into a deflationary spiral and debt deflation still is to be determined.

Odds are that the massive easing of monetary policy by major central banks around-the-world and programs of fiscal stimulus being proposed and implemented will lift economies and aggregate demands sufficiently to prevent any sustained deflation in commodities, goods, or services prices. *But the risk of a deflation that would be more than transient has risen quite a lot in recent months, particularly on the bursting of a price bubble in crude oil and energy prices and its derivative effects.*

In the Baseline, jobs losses over the next year are projected at about 2.7 million on the nonfarm payroll basis and near 2.5 million on the Household Survey, or civilian basis. The resulting unemployment rate is near 8-3/4% by late Summer or early Autumn, representing not quite so large an increase as over the past year.

However, this rate of unemployment likely will understate joblessness, since the structural demographics of the labor force have changed. There is much less labor force growth than used to be the case. Labor force growth, the labor force participation rate and employment-population ratio will continue to decline, reflecting the aging population, retirements of the baby-boomer generation, a peaking-out of the female labor force participation rate and fewer potential workers in the 18-to-30 year old age cohort.

If labor force demographics were as in the 1970s, 1980s or 1990s, the unemployment rate probably would reach 10%-to-11%. Certainly, the total of the unemployed, those part-timers who would prefer to work full-time but are not, and discouraged workers will reach record-high levels.

Household financial conditions and business profits likely will be slow to improve as a result, suggesting that when economic recovery and expansion do return, there will be another "jobless" recovery similar to the ones in 1991-94 and 2002-04.

Tables 4 and 5 indicate two possible alternatives to the Baseline—a "Long and Severe" recession or a "V" recession and upturn.

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Table 4
Decision Economics, Inc. Alternative Scenario—"Long and Severe" Downturn*

	Quarterly (As of January 2009)					Annual			
	2008:4F	2009:1F	2009:2F	2009:3F	2009:4F	2007A	2008E	2009F	2010F
Economy									
Real GDP (% Chg.)	-5.4	-4.7	-3.3	-2.0	-2.3	2.0	1.2	-3.1	-1.1
Consumption (% Chg.)	-4.2	-2.3	-2.0	-1.9	-2.1	2.8	0.2	-2.6	-1.2
Business Fixed Investment (% Chg.)	-10.7	-14.1	-14.0	-12.9	-11.8	4.9	2.4	-10.6	-8.3
Govt. Federal (% Chg.)	0.2	2.7	2.6	3.1	3.3	1.6	5.6	4.4	2.9
Personal Savings Rate (%)	2.3	4.2	5.4	6.2	7.7	0.6	1.6	5.7	9.0
Inflation and Unemployment									
Consumption Price Deflator (% Chg.)	-5.6	-2.5	1.4	1.6	1.9	2.6	3.1	-0.2	1.9
Unemployment Rate (%)	6.9	7.5	8.4	9.4	9.7	4.6	5.8	8.8	10.0
Fed. Bdgt. Def./Surplus (Unified, Fiscal Yrs., $ Bils.)	--	--	--	--	--	-179.3	-546.7	-1531.9	-1391.3
Fed. Bdgt. Def./GDP (%)	--	--	--	--	--	-1.3	-4.0	-10.7	-9.3
Debt-to-GDP (%)	74.3	76.9	82.0	85.1	90.1	65.0	70.7	83.5	92.4

*Source: Decision Economics, Inc. (DE). *No major new policy changes are assumed.* The monetary assumption is "quantitative easing" through 2009 and small, gradual increases in the federal funds rate through 2010.

F-Forecast
A-Actual

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Table 5
Decision Economics, Inc. Alternative Scenario—"V"*

	Quarterly (As of January 2009)					Annual			
	2008:4F	2009:1F	2009:2F	2009:3F	2009:4F	2007A	2008E	2009F	2010F
Economy									
Real GDP (% Chg.)	-6.6	-6.5	0.0	2.4	4.1	2.0	1.1	-2.3	3.4
Consumption (% Chg.)	-5.2	-3.7	1.0	2.3	4.9	2.8	0.2	-1.6	3.0
Business Fixed Investment (% Chg.)	-14.5	-21.4	-1.4	-1.1	3.5	4.9	2.2	-8.5	4.6
Govt. Federal (% Chg.)	0.2	3.7	5.4	6.9	7.2	1.6	5.6	5.8	6.5
Personal Savings Rate (%)	2.7	5.0	4.5	5.2	5.1	0.6	1.6	4.5	4.8
Inflation and Unemployment									
Consumption Price Deflator (% Chg.)	-5.8	-2.9	2.5	2.7	2.8	2.6	3.3	1.5	2.4
Unemployment Rate (%)	6.9	8.0	8.3	8.4	8.1	4.6	5.8	8.4	7.4
Fed. Bdgt. Def./Surplus (Unified, Fiscal Yrs., $ Bils.)	--	--	--	--	--	-179.3	-550.3	-1755.9	-1598.6
Fed. Bdgt. Def./GDP (%)	--	--	--	--	--	-1.3	-4.1	-12.2	-10.5
Debt-to-GDP (%)	74.3	82.7	87.0	93.2	94.5	65.0	68.6	89.3	97.5

*Source: Decision Economics, Inc. (DE). An Obama Economic Recovery Plan of approximately $750 billion fiscal stimulus, 60% federal government outlays and 40% tax relief is assumed. The monetary assumption is "quantitative easing" through 2009 and small, gradual increases in the federal funds rate during 2010.

F-Forecast
A-Actual

The "Long and Severe" Alternative depicts a longer and deeper downturn than the Baseline, lasting through much of 2010. Peak-to-trough, real GDP declines nearly 4% and the unemployment rate reaches 10%.

Here, the forces of the asset price deflation in residential real estate, in the stock market, and for commodities overwhelm the monetary stimulus of low interest rates and quantitative easing. Financial institutions continue to hoard funds because of the capital required to support shrinking balance sheets. Credit losses are bigger. Consumers and businesses become even more pessimistic, refusing to borrow and spend even after the Federal Reserve lends more-and-more into the private sector.

The Fed "pushes-on-a-string" to an enlarged set of financial intermediaries who simply do not lend very much and also "pushes-on-a-string" on credit into housing, to consumers, and businesses who save and do not spend, or borrow, very much. The personal savings rate reaches over 9% by 2010 in this Scenario.

The other Alternative, a much brighter one, indicates a strong recovery and expansion sooner, beginning in Summer 2009.

Fiscal policy stimulus and the direct involvement of the Federal Reserve as a lender-of-last-resort to the *private sector*, not just banks or other financial intermediaries, bear fruit. Federal government spending is lifted much higher despite a winding down of defense spending associated with the withdrawal of U.S. troops from Iraq. Individual income tax reductions and credits are legislated early this year.

Financial institutions and the Federal Reserve aggressively lend, the credit crunch ends, the stock market picks up, housing bottoms-out, and housing prices stop falling. Business sector cutbacks are bigger and quicker and the excesses of the private sector are more quickly resolved. Monetary ease and fiscal stimulus in Japan, China, South Korea, Hong Kong, Australia, New Zealand, the Eurozone, U.K., Canada, and in the oil-producing countries, including Russia, limit the global downturn and its problem for U.S. exports.

Real GDP growth is sharply lower in the fourth and first quarters, down 6%-to-7%, annualized, and the unemployment rate quickly jumps to near 8%. But the very actions that cause this also take down business costs rapidly and, along with even lower crude oil and energy prices, help pick up business profits sooner.

Real GDP growth is down almost 2-1/2% in 2009 instead of the -2.1% in the Baseline but rebounds in the second half and to near 3-1/2% in 2010. With inflation low, the Federal Reserve

can gradually begin to reverse its quantitative easing and slowly raise the federal funds rate in 2010.

Either of these Alternative Scenarios is possible. The range of uncertainty surrounding 2009 and 2010 is extremely high—more dismal to brighter.

Macroeconomic Policy Choices

In the setting that exists, what macroeconomic policy actions are suggested? What is the role of monetary policy? What are the possibilities for fiscal policy stimulus—how much, what mix and dosage, and for how long? What might be the effects on the macroeconomy? What might be the economic and budgetary effects of a possible Obama Administration Economic Recovery Program?

Monetary Policy in Financial and Economic Crises—Lender of Last Resort to the Private Sector? Pluses and Minuses

The first line of defense in an economic downturn, of course, is monetary policy—actions by the Federal Reserve on interest rates and in the provision of reserves and liquidity to the banking system.

In normal circumstances, monetary policy is eased by lowering the key policy short-term interest rate, in the U.S. the federal funds rate, which reduces the costs-of-funds to banks and other financial intermediaries who then lend into housing, to the consumer, and businesses.

Funds availability is increased and, with lags, the combination of lower interest rates and increased availability of funds lifts housing, then consumption, business sales, then profits, and later business spending, production, inventories and employment. The stock and other financial markets improve, consumer spending picks up, and the economy recovers and expands. The U.S. demand for imports rises; other countries' economies improve and global expansion returns.

The present episode differs from the more normal paradigm in the imbalances and excesses that have evolved over a long period of time, booms and price bubbles that have burst for commodities, real estate and stocks, derivative effects on credit, debt, and the securities and firms tied to these, and a collapse in the financial intermediation process. Extremely leveraged debt financing of the expansion, aggressive and excessive risk-taking also have been present.

Just as the leveraged financing and balance sheet expansion produced outsized booms and bubbles in asset prices, credit, debt, in the financial sectors and countries fueled by the rising values of assets and balance sheets, so is the unwinding of them and associated collapse of credit, financial disarray, and restoration of balance sheet equilibria fueling asset price deflation and the curtailment of spending, lending, and borrowing.

Widespread and interactive booms and bubbles have led to a degree of financial instability and financial disarray not usually present, overwhelming the normal easing response of the Federal Reserve, late in coming, but which has become more timely and appropriately aggressive. The long and variable lags in the effects of easier monetary policy on the economy have been made moreso as the dynamics of the downturn, real and financial, and stock adjustments work themselves out, more of them this time. The Federal Reserve has made the appropriate diagnosis—extreme financial instability and a crippled system of credit—and is trying to preserve the credit channel in the economy by taking numerous ingenious and creative actions to support credit and to prevent the wholesale collapse of the banking and financial intermediary system such as occurred in the 1930s.

Open-ended purchases of securities and large injections of reserves into the banking system should be continued, keeping the federal funds rate near zero, U.S. Treasury and other short-term interest rates very low. A program of purchases of commercial paper indirectly from nonfinancial corporations has been a positive innovation.

Second, the funding of financial intermediaries, mostly commercial banks, through the various programs set up in recent months, should be maintained even if the recipients do not use the funds to lend. The financial institutions who receive the funds will act in their own self-interest, but over time eventually heal their balance sheets and loosen up credit within and outside the financial system.

Third, the Federal Reserve will soon use $20 billion of funds from the federal government and the Troubled Asset Recovery Program (TARP) as equity to support $200 billion of lending directly into the private sector—a definite positive step. This probably will not be sufficient and more federal government funding for this purpose would be appropriate.

Fourth, direct purchases of GSE debt to keep mortgage costs-of-financing down and purchases of FNMA and Freddie Mac mortgage-backed securities in the open market should be continued until the housing downturn and housing price declines have ceased.

Finally, the central bank should purchase U.S. Treasury securities across the Treasury yield curve, including long duration U.S. Treasury securities, the 10-year bond, in particular. Long-term mortgage rates will be held down as a consequence and the signs-of-life in mortgage refinancing that have appeared will probably spread and increase. Also, when the U.S. Treasury issues debt to finance the coming record-high deficits, the Federal Reserve can absorb these issues in case others do not.

Essentially, the U.S. central bank has become, and is becoming, a "bank" in the private sector, lending and investing where the current set of banks and financial intermediaries will not. There is hardly any other choice, although some do exist, except for the Federal Reserve to bypass a nonfunctioning credit channel in order to cushion the downturn in the U.S. economy, if not able to reverse it.

The pluses of this approach can already be seen in sharply lower long-term mortgage rates and increased refinancing of mortgages. Also, low short-term interest rates have reduced the cost-of-funds to banks and are increasing banks' Net Interest Margin (NIM). And, the funds pumped into the banking system, which now include some previous investment banks and insurance companies, are helping to recapitalize the banking system in the face of eroding profits and collapsing balance sheets.

Negatives are moral hazard and the potential inflationary effects of what amounts to printing money and almost unlimited expansion of the Federal Reserve's balance sheet.

Nevertheless, despite the actions taken, aggregate demand is so weak and the forces surrounding consumption and business fixed investment so negative, including expectations, likely to keep spending depressed, that the potential looks bleak for a significant upturn based on monetary policy alone. The unprecedented actions taken by the Federal Reserve, however, should eventually bear fruit, although by itself unlikely to stem the U.S. economic decline and propel the economy into recovery.

Fiscal policy stimulus will be needed.

A similar situation, but to a much lesser extent and not so complex as currently, existed in the aftermath of the 2000-2001 recession, where the collapse in technology spending and in the stock market overwhelmed whatever the Federal Reserve could do on interest rates and easy and ample availability of funds. Fiscal stimulus was used, mostly tax reductions, given the relative impotence of monetary policy in any reasonable timeframe and proved to be a major catalyst for U.S. economic recovery and in a derivative manner, the global economy.

The process that got us here suggests that monetary policy and recapitalization of financial institutions by the Federal Reserve and Treasury cannot necessarily prevent an even worse outcome from occurring. Inadequate aggregate demand is not the only source of the downturn. The collapse of credit, unwillingness of banks and financial institutions to lend within and outside the financial system, the effects on U.S. and global economies, asset deflation and perhaps debt deflation indicate that monetary policy could stay impotent or take too long for its effects to appear.

Fiscal stimulus, Keynesian-like, is indicated, with deficit-financed spending and tax reductions supported by easy monetary policy until the U.S. economy is up-and-running in a sustained way and the financial system and risk-taking are restored to more normal, but not excessive, levels.

Fiscal Policy—Some General Comments

Fiscal policy as a stabilization tool has undergone considerable shifts in attention and use over the decades, ranging from a standard tool for stabilizing business cycles in the 1960s and 1970s to a determinant only of the ultimate potential growth and potential level of activity for the economy afterwards.

Part of the change in viewpoint on fiscal policy has to do with its lack of usefulness in conditions unfavorable to its use, for example the hyperinflation circumstances of the late 1960s, 1970s and early 1980s. Also, there are issues of timing and whether fiscal policy stimulus, or restraint, is countercyclical or procyclical once implemented, given recognition lags, gestation lags, political lags, and lags in economic effects. These, in particular, pushed fiscal policy, other than automatic stabilizers, to the backburner for many years. Monetary policy became ascendant and the first line of defense in dealing with cyclical ups-and-downs.

In this last decade, fiscal policy has taken on renewed importance in part because of situations where monetary policy has been overwhelmed by collapses in spending, e.g., a technology bust and stock market price bubble bursting in 2000-02, and currently.

When the diagnosis is a collapse from the demand-side or in the current circumstances a 1930s-like asset price deflation and banking system problem, potentially a debt deflation, and inadequate private sector aggregate demand, then the low interest rates and availability of credit from easy monetary policy become much less potent and fiscal policy potentially more useful as a policy instrument for what ails the economy.

Such is the case now where for over a year easier monetary policy and lower short-term interest rates have failed to stem the U.S. and global downturns; indeed, these have steepened and intensified even as monetary policies everywhere, especially recently, have gotten aggressively easier.

Policy medicine economics, just as medicine in health care, needs to be tailored to the diagnosis of the causes and compared with possible similar episodes, if relevant, much as other illnesses and pathologies for patients are used to help medical doctors prescribe appropriate medicine.

Accommodative and easy financial conditions are a necessary ingredient of any treatment if the risks to the economy far outweigh the risks to inflation over some time horizon, as now. So monetary policy should be kept easy and accommodative as a backdrop to fiscal stimulus, especially the more the slack in product and labor markets.

One issue is the size of a fiscal stimulus. This is difficult since the U.S. economy is much larger now than used to be the case. Thus, the size, in absolute terms, must be higher.

Second, there may be offsetting negative dynamics operating in the macroeconomy to delay or even more than offset whatever fiscal stimulus is implemented. This needs to be accounted for.

Third, even with accommodative monetary policy, the side effects of fiscal stimulus can prove self-defeating, or at least limiting, through negative feedback effects on the positive stimulus of the fiscal action.

For example, fiscal stimulus by definition will initially create higher federal budget deficits and, if permanent, imply permanently higher structural budget deficits. Expectations of future deficits and the financing associated with them can affect the current prices and yields on U.S. Treasury and other securities given the forward discounting that goes on in fixed income markets. This is similarly so for exchange rates. The combination of higher long-term interest rates and perhaps a lower dollar from expected increases in the deficit may feed back negatively on financial markets in the present time and limit the stimulus to the economy of the fiscal action. Higher prices or higher inflation also can be expected and with higher interest rates will reduce the real purchasing power that would occur if there were no inflationary or interest rate feedback.

One positive by-product is the induced gains in tax receipts from all sources that occur when fiscal stimulus acts to raise economic activity, reducing ex-post the net ex-ante budgetary cost of the fiscal action, although rarely eliminating it.

Of course, other policies can be used and mixed with the fiscal stimulus—monetary, regulatory and supervisory, financial markets oriented, or institutional—to achieve desired objectives. There are also distributional effects of fiscal policy and shifts in the macroeconomic policy mix that can affect the microeconomics of the economy and perhaps help in achieving certain social objectives, for example, a reduction of inequality if it is so desired.

But proposals on fiscal stimulus—size, dosage, its legislation and interaction with other policies—remain a complicated and difficult task, especially given the complex dynamics of the

economy in a globalized context and the imprecision of the "science" of policymaking in a stress situation.

Fiscal Policy Alternatives—Size, Permanent vs. Temporary, Dosage, Short- and Long-Term Effects

For fiscal policy, the range of possibilities includes federal government purchases, defense or nondefense, or both, federal government transfer payments perhaps in the form of higher unemployment benefits and support for health care insurance payments of low-income families, aid to states and localities, and programs to support housing. The range of tax policy possibilities includes temporary reductions in personal income taxes, a permanent tax cut for individuals, tax credits for specific purposes, a reduction in the corporate profits tax rate, a reduction in the social security payroll tax, and a reduction rather than a hike in capital gains taxation. These types of fiscal stimulus could be used individually, or together, with size, mix, and dosage to be determined.

Three issues for fiscal policy are the total size of a stimulus package, its mix and dosage, and whether the measure should be permanent or temporary. This is examined in simulations with a large-scale macroeconometric model of the U.S. economy—the Sinai-Boston (SB) Model.[3]

All simulations assume accommodative monetary policy, that is an unchanged federal funds rate compared with the Baseline. The Federal Reserve injects sufficient nonborrowed reserves to maintain the Baseline federal funds rate.

These simulations show longer-term (out to 10 years) results under assumptions of no other exogenous interventions of policy, changes from the paths of the exogenous variables set, and under the assumption of an approximate maintained structure of the economy.

The SB Model is an open economy model with flexible exchange rates and interactions from the U.S. economy to major foreign economies then back to the U.S. through trade, exchange rates, and interest rates. The particular situation that exists now where financial instability, financial crises, and financial disarray characterize a more open global economy with generally flexible exchange rates has not been fully analyzed analytically in the literature, nor otherwise.

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[3] The results of macroeconometric model simulations should properly be noted as approximate, derived from a stochastic dynamic large-scale macroeconometric model. As such, a wide distribution of outcomes is possible. Any given result from econometric model simulation is only one of those outcomes, presumably near the center of the distribution of the probability distribution of all possible outcomes, but not necessarily so. Thus, ranges should be thought of rather than precise point estimates, with any particular episode, or simulation, a single outcome in the range and not necessarily precise in its potential accuracy. Also, simulations of econometric models are based on a model structure estimated on history so that any change in structure in the recent past, or future, not captured in the sample history of the econometric model can make the results less precise, less valid, or even invalid.

But given the elaborated framework of the Model for the financial system and its interactions with the real economy and vice-versa, it is perhaps as well-equipped as any to assess the financial effects on the economy from the changes in fiscal policy.

In Chart 2, the responses of the economy to $100 billion and $500 billion increases of federal government spending are shown in an attempt to assess how much is gained on a bigger stimulus package compared with a smaller one. There is a similar assessment on $100 billion and $500 billion permanent income tax reductions.

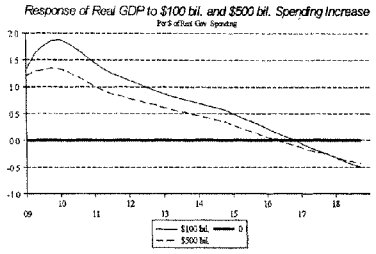
Both show significant multiplier effects but the five-fold higher spending increase and five-fold increase in a permanent personal income tax reduction do not produce similar proportionate increases in economic growth and activity. Indeed, the gains from the additional stimulus are not much greater even in the near-term, certainly not in the longer-term.

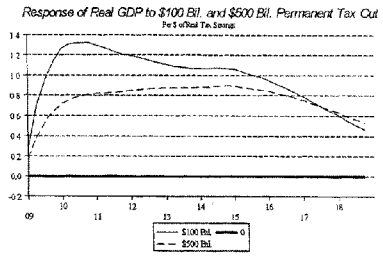
The implication is that serious thought must be given to whether big doses of fiscal stimulus should be used or whether the same total amount should be spread over time. The simulation results do show more gain per unit size for permanent tax cuts than for federal government spending increases.

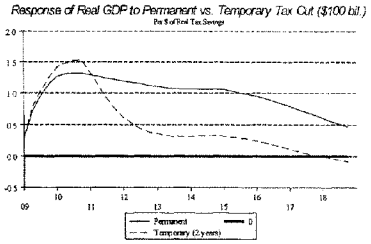
The third subchart in Chart 2 shows the response of real GDP to $100 billion permanent and temporary tax reductions. Here, the temporary tax reduction multiplier is somewhat greater earlier, reaching a peak of 1.5 in the second year but fading quickly thereafter. The permanent individual income tax cut has a similar time pattern of response but sustains a positive real GDP compared with the Baseline throughout the 10-year simulation interval.

Generally, permanent changes in fiscal policy will provide longer-lasting effects on the economy than temporary ones, although budgetary considerations may argue for temporary rather than permanent fiscal stimulus, depending on the circumstances. In any case, once debt is added to the accumulated stock, it is not removed because the fiscal stimulus was temporary. Further accumulation is limited, because new government debt financing does not occur. But, with interest payments on the greater outstanding debt, the cumulated stock of debt grows, and if GDP does not rise faster than the debt from the stimulus or for other reasons, the debt-to-GDP ratio will rise.

Chart 2
Size and Permanent Vs. Temporary Issues*
(Relative to Baseline (Zero))







* Simulation of the SB Model of the U.S. Economy. Federal Reserve policy unchanged; federal funds rate held at Baseline.

Fiscal Policy Alternatives—Effects of Government Outlays and Tax Measures

Charts 3 to 4 show the effects on real GDP, price inflation (overall and "Core"), the unemployment rate, nonfarm and civilian employment of hypothetical $100 billion increases in various types of government outlays. Tables 6 and 7 show the effects of the various types of government outlay stimulus on the unified federal budget deficit, outlays and tax receipts, and in some detail. Changes in the federal budget deficit relative to GDP, the deficit/GDP ratio, in gross public debt, and in debt-to-GDP are indicated.

The Charts have subcharts that show 1) the "multipliers" for each of the fiscal alternatives, 2) real economic growth compared with the Baseline, 3) inflation, 4) the unemployment rate relative to the Baseline, 5) jobs created on the nonfarm payroll and 6) civilian bases.

Virtually all the fiscal stimulus programs raise the deficit-to-GDP ratio, with increases in the budget deficit relative to GDP exceeding early year rises of GDP. But revenue feedback from all sources of taxes as a result of fiscal stimulus reduces the ex-post deficits, sometimes quite considerably compared with those ex-ante. Debt-to-GDP ratios generally rise throughout, however, made even higher by increases of longer-term interest rates from changes in expected future deficits and U.S. Government debt accumulation.[4]

In Chart 3 is seen the relatively quick and sharp impact of federal government purchases in raising real GDP. The government purchases multiplier ranges between 1.4 and 1.8 over the first two years of the simulation, sizeable effects, then tails off, although still relatively, high before returning to Baseline levels in 2017.

Growth in real GDP is quite strong relative to the Baseline in the first year, but quickly falls back to the Baseline path in 2010. The unemployment rate drops quickly and sharply from strong hiring by the federal government, falling almost 0.8 percentage points below the Baseline, staying lower for quite some time given permanently higher employment in the federal government sector and the rising portion of the economy in federal government activity. *The SB Model disaggregates nonfarm payroll employment into six subsectors so can differentiate the employment effects of the various programs between the public and private sectors.*

Inflation, as measured by the Consumption Price Deflator-Overall and Ex-Food and Energy (Core), rises only by 0.2 to 0.3 percentage points compared with the Baseline. Jobs creation, on the nonfarm payroll basis, is strong, totaling 2-1/2 to 3 million over the first two years of the

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[4] Model-consistent expectations of future real federal budget deficits per capita are iterated in the Model with the long-term U.S. Treasury 10-year rate and AAA-Corporate Equivalent yield for the current period. Changes in the volume of gross public debt affect the three-month Treasury bill rate, other related short-term securities yields, and through arbitrage or term structure effects long-term interest rates as well.

Chart 3
Federal Government Purchases Permanently Higher by $100 Billion*
(Changes Relative to Baseline)

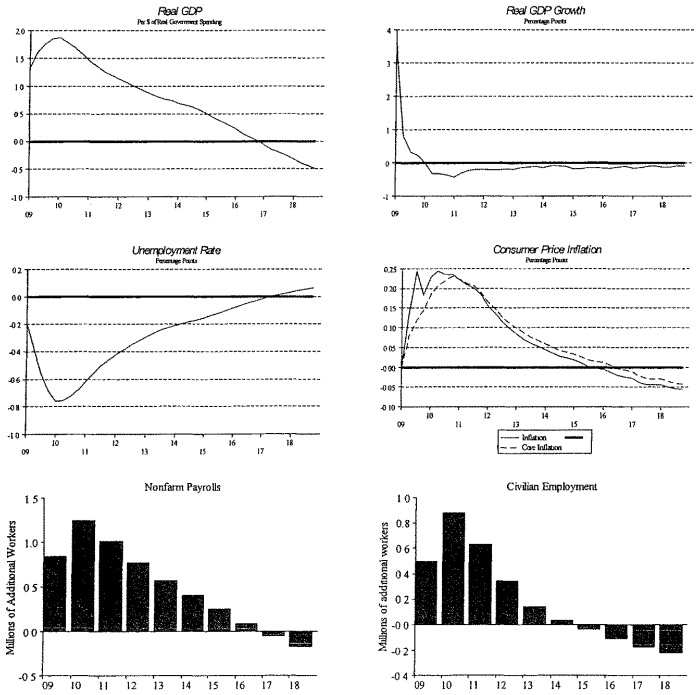


Table 6
Budgetary Effects of Fiscal Policy Stimulus:
$100 Billion Permanent Increase of Government Spending
(Diffs. From Baseline Unless Otherwise Indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Unified Federal Budget Deficit/Surplus (-/+) ($ Bils.)	-47.5	-22.4	-30.2	-52.6	-71.8	-87.6	-102.2	-120.9	-142.7	-164.8
Tax Receipts	18.6	36.1	39.4	40.9	41.2	40.6	39.5	36.4	32.6	28.6
Corporate	5.4	8.5	6.5	5.1	4.2	3.8	3.0	1.9	0.8	0.0
Personal	6.3	14.7	18.4	20.5	21.2	20.9	20.6	19.6	18.1	16.3
Ordinary Income	6.1	12.4	15.4	17.9	19.0	19.2	19.4	19.0	18.3	17.1
Capital Gains	0.1	2.3	3.0	2.7	2.2	1.7	1.2	0.6	-0.1	-0.7
Social Insurance	5.8	11.4	12.8	13.6	14.0	14.2	14.1	13.3	12.1	10.8
Excise	1.1	1.5	1.6	1.7	1.8	1.8	1.8	1.7	1.5	1.4
Outlays	73.5	55.7	75.9	99.0	117.5	132.1	146.0	162.8	181.0	198.9
Federal Purchases	86.8	86.8	86.8	86.8	86.8	86.8	86.8	86.8	86.8	86.8
Transfers-to-Persons	-14.7	-35.1	-17.8	1.8	16.1	26.3	34.9	44.8	54.3	61.9
Grants-in-Aid	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Interest	1.5	4.0	7.0	10.4	14.6	19.0	24.4	31.2	39.8	50.2
Gross Public Debt ($ Bils. Diff.)	70.4	123.3	179.9	277.2	409.9	573.2	764.1	987.2	1247.8	1546.5
Deficit/GDP (Pct. Pts.)	-0.2	-0.1	-0.1	-0.3	-0.3	-0.4	-0.4	-0.5	-0.6	-0.7
Debt/GDP (Pct. Pts.)	-0.4	-0.4	-0.1	0.5	1.1	1.9	2.7	3.7	4.8	5.9

Source: Decision Economics, Inc. (DE). *Simulation of the SB Model of the U.S. Economy.* Federal Reserve policy unchanged; federal funds rate held at Baseline.

spending increase. The discrepancy between the increases in nonfarm payrolls and of civilian, or Household Survey, employment reflects the count in nonfarm payrolls of jobs rather than persons employed.

In Chart 4, a permanent $100 billion increase in federal government transfer payments, increasing and extending unemployment benefits, is examined. Transfers do not directly impact real GDP as do federal government purchases but work to raise the level of economic activity and the rate of economic growth through the expenditures of the recipients, in the Model acting more like a tax reduction than an increase in government spending.

Here, *transfers are seen to have a slower, but significant multiplier effect on real GDP that lasts through the simulation interval.* Real economic growth is higher, longer, than with federal government purchases, but the unemployment rate does not decline as much. Nonfarm payroll jobs increase less robustly than for an equivalent $100 billion increase in federal government purchases but the Household Survey employment figures are stronger. *This reflects the more widespread breadth of the stimulus as it works through consumer spending to produce broader effects on employment, although not so strong as federal government purchases where increases in federal government employment are greater.*[5]

The budgetary effects of federal government purchases versus transfers to individuals are reflected in Tables 6 and 7, although the increases in the deficit/GDP and debt/GDP ratios are similar. It is the mix of outlays that show a considerable difference.

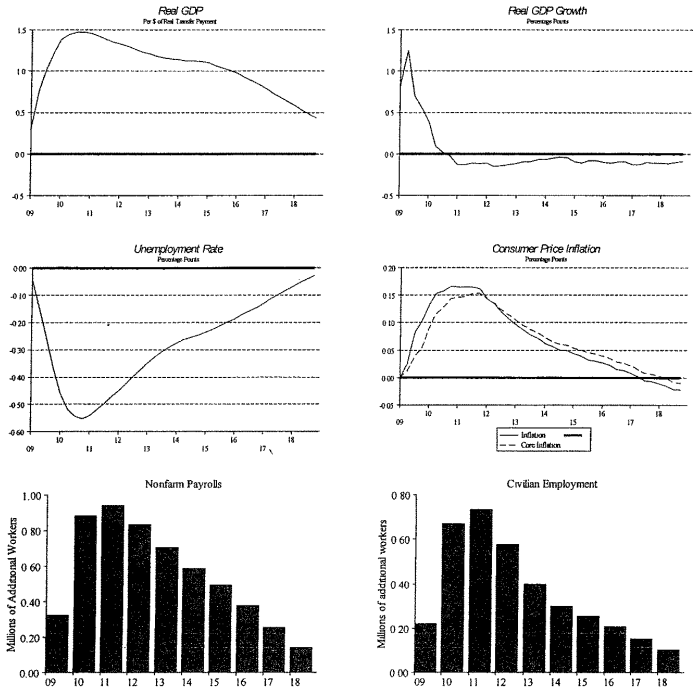
In Chart 6 and Table 8 are shown the results from a permanent $100 billion reduction in individual income taxes. The tax multipliers and effects on real GDP, inflation and unemployment, and jobs, both nonfarm and civilian, are provided relative to Baseline.

The increases in real GDP from tax reductions take longer, because the funds transferred from the federal government to individuals work through household spending, which is delayed. The increases in disposable income that occur are not immediately factored in as permanent on the permanent income hypothesis that is embodied in the Model. There is also about a one-year lag with respect to changes in household wealth. Short-run propensities-to-consume are higher for cashout financing and capital gains realizations but these do not change much in the shorter-term on these types of policies, except for the elimination of the individual capital gains tax.

There is a financial side to the tax reduction for individuals such that the funds not spent are "saved" and show up in household finances and household balance sheets, improving household

[5] In the SB Model, nonfarm payroll employment is modeled as the aggregate of a number of subsectors including separately federal government, various categories of services, manufacturing, and retail trade.

Chart 4
Permanent $100 Billion Increase in Federal Government Transfer Payments*
(Changes Relative to Baseline)



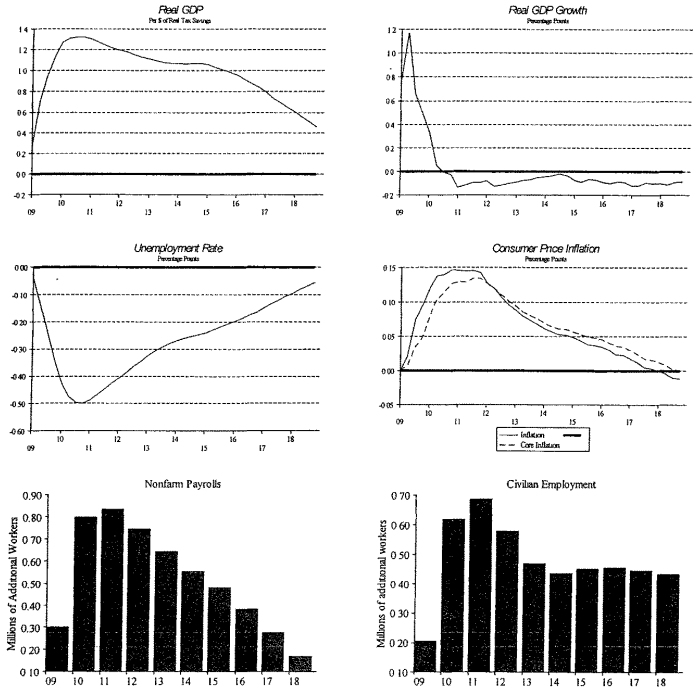
*Simulation of the SB Model of the U.S. Economy. Federal Reserve policy unchanged, federal funds rate held at Baseline.

Table 7
Budgetary Effects of Fiscal Policy Stimulus:
Permanent $100 Billion Increase of Federal Government Transfers to Individuals
(Diffs. From Baseline Unless Otherwise Indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Unified Federal Budget Deficit/Surplus (-/+) ($ Bils.)	-68.7	-57.9	-48.1	-58.6	-73.3	-86.4	-97.2	-111.2	-129.2	-150.0
Tax Receipts	10.3	29.7	37.4	41.7	44.5	46.6	48.7	49.0	47.9	45.8
Corporate	4.3	9.3	8.7	7.8	7.4	7.3	7.2	6.6	5.8	5.1
Personal	3.0	11.3	16.5	19.8	21.7	22.7	24.0	24.6	24.6	23.8
Ordinary Income	2.9	9.0	13.1	16.1	17.7	18.7	20.1	21.0	21.3	20.9
Capital Gains	0.1	2.3	3.4	3.7	4.0	4.0	3.8	3.7	3.3	2.9
Social Insurance	2.4	8.0	10.8	12.5	13.8	14.7	15.5	15.8	15.6	15.0
Excise	0.5	1.1	1.4	1.5	1.7	1.8	1.9	2.0	1.9	1.9
Outlays	96.5	81.2	87.7	104.4	121.8	136.3	149.4	164.9	182.7	201.6
Federal Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transfers-to-Persons	94.4	75.6	78.3	90.9	103.5	113.1	120.7	129.7	139.5	149.1
Grants-in-Aid	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Interest	2.1	5.6	9.5	13.4	18.3	23.3	28.7	35.2	43.2	52.5
Gross Public Debt ($ Bils. Diff.)	102.0	218.1	311.4	421.6	557.7	719.2	901.7	1108.1	1345.0	1617.1
Deficit/GDP (Pct. Pts.)	-0.4	-0.3	-0.2	-0.3	-0.4	-0.4	-0.4	-0.5	-0.5	-0.6
Debt/GDP (Pct. Pts.)	0.3	0.5	0.9	1.4	2.0	2.6	3.3	4.1	5.0	6.0

Source: Decision Economics, Inc. (DE). Simulation of the SB Model of the U.S. Economy. Federal Reserve policy unchanged; federal funds rate held at Baseline.

Chart 5
Permanent $100 Billion Tax Cut
(Changes Relative to Baseline)*



*Simulation of the SB Model of the U.S. Economy. Federal Reserve policy unchanged; federal funds rate held at Baseline.

Table 8
Budgetary Impact of Permanent Tax Cuts: $100 Billion
(Diffs. From Baseline Unless Otherwise Indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Unified Federal Budget Deficit/Surplus (-/+) ($ Bils.)	-69.6	-63.4	-57.1	-67.4	-81.0	-92.9	-102.8	-116.0	-133.3	-153.7
Tax Receipts	-90.9	-74.6	-68.8	-64.8	-62.0	-59.7	-57.2	-56.4	-56.9	-58.3
Corporate	4.0	8.1	7.2	6.7	6.5	6.7	6.8	6.3	5.7	5.1
Personal	-97.6	-91.0	-86.9	-84.1	-82.5	-81.5	-80.2	-79.4	-79.2	-79.7
Ordinary Income	-97.6	-92.4	-89.0	-86.5	-85.0	-84.0	-82.6	-81.7	-81.1	-81.2
Capital Gains	0.0	1.5	2.1	2.3	2.5	2.5	2.4	2.2	1.9	1.5
Social Insurance	2.3	7.3	9.7	11.3	12.5	13.5	14.4	14.8	14.8	14.4
Excise	0.5	1.0	1.2	1.4	1.5	1.7	1.8	1.9	1.9	1.8
Outlays	-3.0	-16.3	-9.3	6.3	22.6	36.1	48.8	64.1	81.8	101.1
Federal Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transfers-to-Persons	-5.2	-22.5	-19.6	-8.4	2.5	10.8	17.6	25.9	35.4	44.9
Grants-in-Aid	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Interest	2.3	6.1	10.3	14.7	20.1	25.4	31.2	38.1	46.4	56.2
Gross Public Debt ($ Bils. Diff.)	103.4	228.0	336.6	462.7	612.9	786.1	978.8	1194.1	1438.6	1717.4
Deficit/GDP (Pct. Pts.)	-0.4	-0.4	-0.3	-0.3	-0.4	-0.4	-0.4	-0.5	-0.5	-0.6
Debt/GDP (Pct. Pts.)	0.3	0.7	1.2	1.7	2.4	3.0	3.8	4.6	5.5	6.4

Source: Decision Economics, Inc. (DE). Simulation of the SB Model of the U.S. Economy. Federal Reserve policy unchanged; federal funds rate held at Baseline.

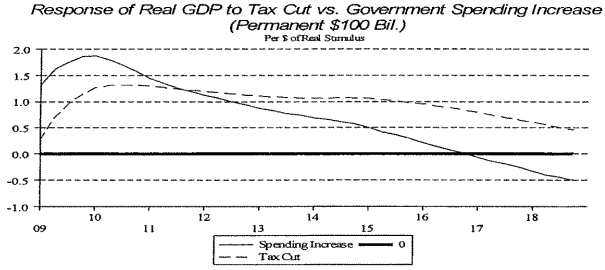
financial conditions and is where the tax reduction has an initial impact. The improvements lead to more spending later and help sustain the gains in the levels of real GDP for the long-term.

For example, if shown, the Household Financial Conditions Index of Chart 1 would be much improved on a tax reduction for individuals, moreso if permanent, with the saved funds showing up in the household flows-of-funds and in various places on the balance sheet that provide support for additional spending later. Improved household balance sheets are a source of support for higher spending, permanently higher economic activity and a longer period of increased growth and lower unemployment, relative to the Baseline.

Finally, Chart 6 superimposes the results of a permanent $100 billion tax reduction against a $100 billion increase in federal government outlays. The *Model simulations indicate more power for longer on tax reductions than increases in federal government spending. A different distribution of jobs creation occurs on the nonfarm payroll basis under a program of tax reductions than from increases in federal government purchases.*

Chart 6

Response of Real GDP to Tax Cut vs. Government Spending Increase
(Permanent $100 Bil.)



If major sources of the current economic crisis are the consumer, the deteriorated financial condition of households, and weakness in the private sector, the results indicate that increasing federal government purchases alone, or transfer payments, although an appropriate component of fiscal stimulus, should be combined with tax reductions, most probably permanent, to get maximum sustainable improvement in the economy and in jobs.

Perhaps most surprising on the exercises on tax relief is limited negative effects on the federal budget deficit as tax receipts on ordinary income, corporate profits, payroll, and excise taxes move up on the stronger economy, at least initially, and transfers-to-persons are reduced.

A Possible Obama Economic Recovery Program—Preliminary Results

A possible Economic Recovery Plan of the Obama Administration is simulated with the results shown in Chart 7, Table 10. Table 9 spells out the assumptions on the details of the two-year program and for the outyears as well. The Program net stimulus is $737 billion over 2009-10 and $1.8 trillion from 2009 to 2018. In 2009-10, federal government outlays total $437 and net Tax Relief $300 billion, making the outlays over these two years as a percent of the total 59.3% and tax relief 41.7%.

The program spending increases spread across government purchases, transfers to individuals for unemployment benefits and health care, aid to states and localities, and housing. The tax reductions are net and mostly for middle- and lower-income families. The current law on capital gains and dividend taxation is not altered, but the lower capital gains and dividend tax rates are allowed to expire at the end of 2011.

Federal government outlays are divided between infrastructure spending, $102 billion in the first two years; transfers to individuals for unemployment benefits and health care support, $160 billion; aid to states and localities $60 billion; medical technology support $80 billion; and "help for housing" of $35 billion. These estimates are just that and do not foreshadow what the ultimate Obama Administration Plan might be for outlays—the "scenario" and figures are meant as approximations of a hypothetical program.

On "Tax Relief," over 2009-2010 $200 billion of permanent marginal income tax rate reductions are indicated with $100 billion in tax credits. A list of possible tax credits is in Table 10. Beyond 2010, the Bush Administration lower marginal income tax rates on higher income families are assumed to expire and the capital gains and dividend tax rates on upper income families to increase to 20% from 15%. These figures offset some of the stimulus of the Obama Economic Recovery Plan which is also long-run in nature particularly on government infrastructure spending.

The deficit-to-GDP ratios on the Economic Recovery Plan rise into a range of -8% to -10% in 2009-2010, falling thereafter but remaining quite high relative to history, at -6%-or-more. The ratio of gross debt-to-GDP soars into the mid-80% range and reaches over 100% by 2016.

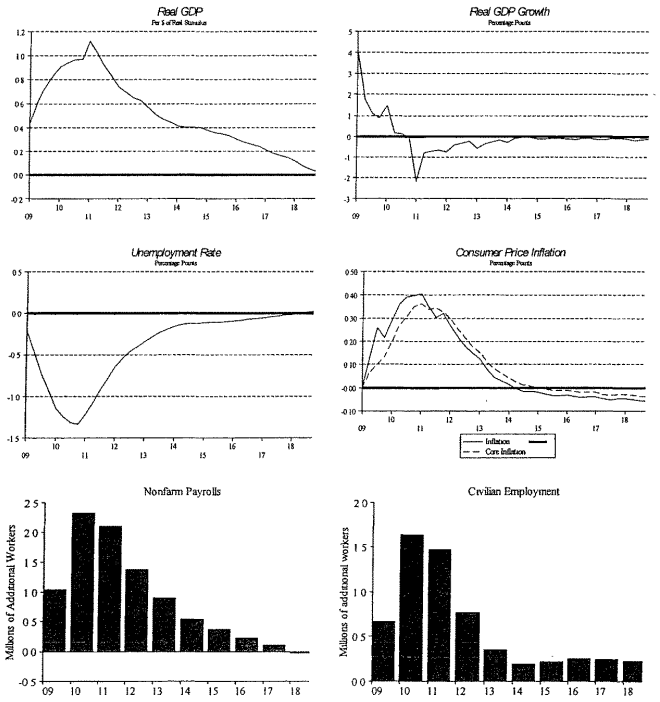
Chart 7 and Table 10 show some effects of the Economic Recovery Plan and its budgetary impacts, respectively. The Program is assumed to start in the first quarter of 2009.

Table 9
A Possible Economic Recovery Program*

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Cum. 2009-10	Cum. 2009-18
Federal Government Purchases of Goods and Services												
Infrastructure spending												
National Infrastructure Bank	6	6	6	6	6	6	6	6	6	6	12	60
Infrastructure Outlays	35	55	37.5	37.5	37.5	37.5	37.5	37.5	37.5	37.5	90	390
Subtotal	41	61	43.5	43.5	43.5	43.5	43.5	43.5	43.5	43.5	102	450
Unemployment Benefits and												
Health Care Support	20	30	15	10	5	0	0	0	0	0	50	80
Subsidize Medicaid	55	55	0	0	0	0	0	0	0	0	110	110
Other Goods and Services												
Help Medical Providers												
Buy Info. Technology*	40	40	0	0	0	0	0	0	0	0	80	80
Aid to States and Localities	25	35	25	15	5	0	0	0	0	0	60	105
Help for Housing	20	15	0	0	0	0	0	0	0	0	35	35
Subtotal for Outlays	201	236	83.5	68.5	53.5	43.5	43.5	43.5	43.5	43.5	437	860
* Treated as government asset. (Federal Government assumed to have some role in purchase of machinery for medical records.)												
Tax Relief												
Marginal Rate Reduction	100	100	100	100	100	100	100	100	100	100	200	1000
Tax Credits	50	50	50	50	50	50	50	50	50	50	100	500
Education												
Expand Earned Inc. Tax Credit												
Expand Child Care Credit												
Making Work Pay												
Universal Mortgage												
Expand Savers Credit												
Exemption for Seniors												
Permanent R&D and Renewable Energy Credits												
Subtotal for Tax Relief	150	150	150	150	150	150	150	150	150	150	300	1500
Total Stimulus											737	2360
Revenue Increases												
Raise top two tax rates (upper incomes)			-34	-41	-47	-53	-59	-65	-71	-77	0	-447
Raise cap. gains & dividend tax rates on upper incomes			-7.4	-3.2	-18.4	-18.4	18.4	-18.4	-18.4	-18.4		-121
Revenue Subtotal												-568
Total Tax Increases												-568
Net Stimulus											737	1792

* Based on fragmentary accounts of a possible policy stimulus. Hypothetical for purposes of simulation.

Chart 7
Obama Administration Economic Recovery Plan
(Changes Relative to Baseline)*



*Simulation of the SB Model of the U.S. Economy. Federal Reserve policy unchanged; federal funds rate held at Baseline.

Table 10
Budgetary Effects of an Obama Administration Economic Recovery Plan
(Diffs. From Baseline Unless Otherwise Indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Unified Federal Budget Deficit/Surplus (-/+) ($ Bils.)	-260.9	-310.5	-149.7	-139.0	-155.7	-173.7	-185.2	-196.9	-212.4	-220.2
Tax Receipts	-124.9	-87.0	-36.3	-37.1	-23.3	-26.3	-22.0	-18.5	-15.4	4.1
Corporate	7.9	14.9	13.0	10.3	8.8	7.9	7.6	6.9	6.3	5.5
Personal	-141.9	-125.4	-76.6	-73.5	-57.2	-58.0	-52.8	-47.9	-43.2	-21.6
Ordinary Income	-141.8	-127.3	-86.2	-78.8	-74.3	-70.0	-64.2	-58.6	-53.3	-31.1
Capital Gains	-0.1	1.9	9.7	5.3	17.1	12.0	11.3	10.6	10.1	9.5
Social Insurance	7.6	20.5	24.5	23.4	22.4	21.1	20.6	20.0	19.1	17.9
Excise	1.5	2.9	2.8	2.7	2.7	2.7	2.7	2.6	2.5	2.3
Outlays	152.5	165.1	72.1	111.8	135.3	150.3	166.3	182.7	201.9	224.2
Federal Purchases	35.6	52.9	37.8	37.8	37.8	37.8	37.8	37.8	37.8	37.8
Transfers-to-Persons	57.0	27.6	-26.5	14.3	37.3	48.7	56.1	63.1	71.8	80.2
Grants-in-Aid	50.0	60.0	25.0	15.0	5.0	0.0	0.0	0.0	0.0	0.0
Net Interest	9.9	24.5	35.8	44.8	55.3	63.9	72.5	81.8	92.4	106.2
Gross Public Debt ($ Bils. Diff.)	323.6	794.4	1080.6	1329.5	1616.4	1934.4	2276.2	2638.6	3027.2	3431.9
Deficit/GDP (Pct. Pts.)	-1.6	-1.8	-0.8	-0.7	-0.8	-0.8	-0.8	-0.8	-0.9	-0.9
Debt/GDP (Pct. Pts.)	1.0	2.9	4.6	5.9	7.2	8.4	9.6	10.9	12.2	13.5

Source: Decision Economics, Inc. (DE). Simulation of the SB Model of the U.S. Economy. Federal Reserve policy unchanged; federal funds rate held at Baseline.

Real GDP growth rises considerably, relative to Baseline, through this year and most of 2010. The multiplier effects on real GDP are sizeable and considerable. The unemployment rate is 1.3 percentage points lower by late 2010 compared with the Baseline, a major decline. Inflation is slow to respond but does move higher, overall and in the Core, by about 0.4 percentage points in 2010. *However, if the Baseline inflation rate stays low or a deflationary spiral starts to develop, this increase would be welcome. Jobs creation, or the prevention of jobs losses, is substantial, almost 3-1/2 million nonfarm payroll jobs cumulatively over 2009 and 2010.*

The negative budgetary side effects are considerable, however, with a substantial increase in the federal budget deficit as a proportion of real GDP, 1.6 and 1.8 percentage points, respectively, over 2009 and 2010, to levels from -8% to possibly as high as -10%. *These are about double what occurred under the Reagan Administration in the 1980s and early 1990s.*

The gross public debt moves significantly higher and by 2018 is $3.4 trillion above the Baseline. The debt-to-GDP ratio, already high from the cyclical rises of deficits and structural requirements of mandatory government spending, moves up even more, by 2012 six percentage points above the Baseline and at the end of the simulation horizon in 2018, 13.5 percentage points higher. *Thus, the gross debt-to-GDP ratio of the United States moves quite a lot higher, reaching over 100%, a figure not seen since W.W.II when this ratio exceeded 105%.* Issues relating to long-term interest rates, the U.S. dollar, and changes in global economic power and wealth would be raised by this kind of result.

No Obama Exit Plan is conjured up for the problem of rising deficits and rising debt off the hypothetical Economic Recovery Plan that was simulated.

Deficit and Debt Prospects—Can the U.S. Afford All of the Stimulus In-Process and Planned?

Under virtually all circumstances, the prospects are for record-high U.S. federal government budget deficits and gross public debt outstanding relative to GDP. The deficit and debt burdens of the federal government are rising sharply and will do so under almost any scenario currently plausible for the U.S. economy and financial markets.

Why is this so?

One reason is cyclical—an economic downturn that arguably will be the worst since the 1930s. The loss in tax receipts and increases in federal government spending as a result are a major reason for the recent sharp deterioration of U.S. Government finances. Over the first quarter of the fiscal year, the cumulative federal budget deficit was approximately -$485 billion.

The Baseline estimate for FY2009 is -$1.4 trillion. The declines in tax receipts also include a huge drop in capital gains taxes and in capital gains realizations given the 40% decline in the U.S. stock market during 2008. Capital gains realizations on residential real estate also are declining. Capital gains tax receipts can cause sharp swings in the federal budget deficit or surplus.

Second are the mandatory entitlements spending of the federal government for retirement, Medicare, and Medicaid. With an aging population, more Social Security retirees, rising costs of health care and in the numbers of beneficiaries, this category of government outlays is perhaps the biggest source of the structural budget deficits going forward that also will reach record highs.

Third is the outlays occasioned by federal government support of the financial system in such programs as the Troubled Asset Relief Program (TARP), nearly $300 billion of which has been spent since October. Expenditures for Iraq and Afghanistan also underlie the federal budget deficit and its deterioration.

Tax reductions over 2001 to 2005 from the Bush Administration are contributing to the deficits as well. But the biggest swing currently has to be cyclical and from the use of taxpayer monies to support the financial system.

Table 11 shows the Decision Economics, Inc. (DE) deficit projections on a Baseline scenario extending out to 2019. The Baseline projections reflect average annual growth in real GDP beyond 2011 of 2-1/2% to 2-3/4% per annum. The unemployment rate averages near 6%. Inflation, measured by the CPI, runs in the 2-1/4% to 2-1/2% range. This Table does not assume an Obama Economic Recovery Plan. The federal government support programs for financial institutions and the financial markets are included in these estimates.

A worse recession or 1930s-like result would make these Baseline figures considerably worse; a "V"-like upturn would lead to improvement. But, even here, the deficits and rising debt-to-GDP ratios would persist.

Table 12 shows the resulting deficits under approximately an $800 billion Economic Recovery Program along the lines simulated earlier. Here, the deficits soar even higher, much higher, in fiscal years 2009 to 2011 and exceed $1 trillion for nearly all of the next decade.

The debt implications are striking with gross federal debt as a percent of GDP rising from the current approximate 70% to over 100% in 2016-to-2019. These figures match W.W.II levels. Debt held by the public, which excludes holdings of the debt by the federal government, rises similarly to record-highs between 75% and 80%.

Table 11
DE Budget Baseline—2008-2019
(Bils. Unless Otherwise Noted, Fiscal Years)

	Actual 2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
DE Deficit	-455	-1408	-1167	-721	-656	-685	-727	-806	-906	-104	-1127	-1259
% of GDP	-3.2	-9.8	-7.8	-4.5	-3.9	-3.8	-3.9	-4.0	-4.4	-4.7	-5.0	-5.4
Receipts	2524	2382	2236	2727	2898	3090	3261	3406	3554	3718	3579	4047
% of GDP	17.7	16.6	14.8	17.1	17.2	17.3	17.5	17.4	17.4	17.4	17.3	17.2
Outlays	2978	3975	3292	3448	3553	3776	3988	4212	4459	4723	4006	4306
% of GDP	20.9	26.4	21.8	21.6	21.1	21.2	21.4	21.5	21.6	22.0	22.3	22.6
Gross Federal Debt	9986	11789	12710	13569	14373	15202	16066	16998	18013	19112	20315	21630
% of GDP	70.2	82.2	84.2	85.0	85.2	85.3	86.1	87.0	88.0	89.2	90.6	92.1
Deficit Held by the Public	5803	7457	8177	8832	9427	10049	10710	11444	12270	13188	14219	15373
% of GDP	40.8	51.9	54.2	65.3	55.9	56.4	57.4	58.5	60.0	61.5	63.4	65.4

Table 12
DE Budget Baseline—2008-2019
With an Economic Recovery Plan of About $800 Billion
(Bils. Unless Otherwise Noted, Fiscal Years)

	Actual 2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
DE Deficit	-54	-1825	-1272	-1092	-974	-1006	-1035	-1117	-1243	-1578	-1524	-1589
% of GDP	-3.2	-12.7	-8.4	-6.8	-6.6	-6.6	-6.5	-6.7	-6.1	-6.4	-6.8	-7.2
Receipts	2524	2183	2295	2521	2704	2899	3074	3228	362	3511	3672	3631
% of GDP	17.7	15.2	15.2	15.8	16.0	16.3	16.5	16.5	16.4	16.4	16.4	16.3
Outlays	2978	4007	3571	3615	3678	3906	4107	4338	4605	4890	5195	5520
% of GDP	20.9	27.8	22.8	22.7	22.6	21.8	21.9	22.0	22.2	22.5	22.8	23.2
Gross Federal Debt	8986	12137	13495	14668	15742	15842	17967	18161	20462	21671	23410	25088
% of GDP	70.2	84.4	89.4	91.9	93.3	94.5	96.2	98.0	100.0	102.1	104.3	106.8
Deficit Held by the Public	5903	7838	9036	10035	10924	11844	12789	13811	14950	16207	17835	18157
% of GDP	40.8	54.5	59.8	62.9	64.8	66.4	68.5	70.7	73.0	75.6	78.5	81.6

The deficit and debt prospects under almost under scenario are daunting, with deficit-to-GDP and debt-to-GDP ratios not seen before in a G-7 country. This territory is uncharted with no real historical analogue to this kind of financial situation for a major global economic power.

The deficit and debt prospects cannot be benign, however. Sometime during the next several years the U.S. economy will recover and inflation begins to pick up. The deficits in-process and to-come from policy stimulus by the federal government and Federal Reserve set the path of debt accumulation on a very high plane. With potential economic growth much lower than historically, debt will be rising faster than GDP, burdening future generations with interest payments, financing and repayment that almost certainly will lead to much diminished U.S. economic growth, on average, and a reduced standard-of-living.

The answer to whether the U.S. can afford all of the initiatives on its wish list—economic, societal, defense, and otherwise—is no!

Financial Market Effects of Rising Deficits and Debt

The rising federal government deficits and outstanding debt of the federal government most certainly will result in some sort of restraint on U.S. economic growth, a potential reinflation, or both in the years ahead.

The financing of these prospective deficits, debt, and the rolling over of outstanding indebtedness will result in a huge volume of Treasury financing in the quarters and years ahead—dwarfing anything seen in U.S. history including the huge Treasury financing of the Reagan years and in the recent years of the Bush Administration.

The current situation is one of a shortage of U.S. Treasury securities given the "safe haven" nature of U.S. federal government debt in the eyes of U.S. citizens and around-the-world. Despite the current economic situation and prospects for rising deficits and debt, the U.S. dollar has done well against most major currencies except the yen, benefiting from safe haven status and the distress, both economic and financial, that other major countries are facing.

However, the U.S. is contemplating larger fiscal stimulus and providing more support to the financial system through the Federal Reserve than most other countries so that the financial exposure of the U.S. Government is greater.

At some point, when some sort of cyclical recovery occurs in the U.S. and elsewhere, the dollar and U.S. Treasury securities will no longer be a safe haven repository for investors from around-the-world and the demand for U.S. Treasury securities will diminish. There already are signs of this happening.

The huge financing necessary will have to be done by U.S.-based investors out of savings, meaning less spending. It is almost inconceivable that other countries, whether China, Russia, Japan, the Middle East oil-producers, or others will allocate as much investment to U.S. Treasuries as previously, especially at such low rates of return.

Interest rates will have to rise and the dollar decline to equilibrate the demands and supplies for U.S. Treasury securities and the U.S. currency, suggesting a weaker stock market and less U.S. economic growth. Higher interest rates than otherwise and a weaker stock market with perhaps less investments into the U.S. for other areas as well suggests that U.S. saving from households and businesses will have to rise to absorb the financing of these huge deficits and accumulated debt.

Of course, the Federal Reserve can always buy and absorb the Treasury securities, especially given the low proportion of Treasuries in its portfolio currently. But, once the global economy has recovered, the purchasing and absorption of large volumes of Treasury securities by the Federal Reserve would be inflationary, contributing to higher inflation, less purchasing power, and less U.S. real economic growth.

Once a country has locked-in deficits and accumulating debt along with the repayments, rolling-over, and interest on that debt, less is available for productive use and a step down the line of diminished economic power and wealth has been taken.

The financial markets would be the principal focal point for the time when the soaring deficits and debt of the federal government would tip the U.S. toward another downturn or simply much less trend growth and a diminished standard-of-living.

Possible Actions

What actions, or options, are available to deal with the prospect of rising deficits and rising debt and the burdens presented on the U.S. economy, economic growth, and U.S. economic performance prospects?

There are some choices—none really pleasant.

1) Do nothing—simply let economic and financial market forces take their course. In this situation, the deficit and debt burdens would be much as is shown in the DE Baseline prospect. However, this is hardly an option and does not deal with the problem of creditworthiness for the U.S. Government and the financial fragility embodied in the projections shown above.

2) Provide less fiscal stimulus in response to the current situation and let the economy languish more than it might otherwise, or a stretching-out of the $800 billion-or-so economic stimulus program that is emerging in Washington. Massive fiscal stimulus along with all the

other financial requirements of the U.S., including for health care and for an aging population, would simply have to be unsatisfied and could be spread over time to slow the pace of growth in the deficits and debt to allow more rapid growth in the economy and thus a balancing of the deficit-to-GDP and debt-to-GDP ratios.

3) Change the composition of the fiscal stimulus—more on tax reductions than increases in government spending. Lower taxes historically provide more stimulus to the private sector and U.S. equity markets than does federal government spending. Focusing on tax cut stimulus that might lead to higher asset prices—for example, on real estate and stocks—could help increase tax receipts through greater capital gains realizations which are lacking now. The incentive effects of marginal tax rate reductions and increase in real aftertax returns to investors have been a major source of expansion in the U.S. economy. Heavy emphasis on federal government spending historically has not produced the same results as reductions in individual and business taxes.

4) Actions to raise taxes to close the gap and slow the accumulation of debt is a possibility, necessary earlier rather than later since debt will continue to grow on every increase in the budget deficit with interest payments on the debt requiring more debt financing as well.

Raising taxes on upper income families is one possibility. Eliminating the carried interest contingency is yet another. Changing the tax system and instituting a VAT with exceptions is yet another possibility. But, tax increases, while helping to close the budget gap and to slow the growth of debt, would restrain an already restrained economy from growing faster.

5) PAYGO for the longer-run and/or phase-out of tax and spending stimulus—the fiscal stimulus likely to emerge from Washington could contain in its legislation mechanisms that would provide for a sunsetting of both spending and tax stimulus and a reinstatement of PAYGO for over a multiyear basis. Legislating PAYGO has worked before but is difficult to do.

6) Expenditure reductions—the preferred way to keep the federal budget deficit down and to slow the growth in federal government debt. Reductions in wartime expenditures, for example on Iraq and Afghanistan, more efficient government spending, and most importantly coming to grips with the spending related to retiring Americans and health care would be desirable. This is perhaps the toughest problem of all, but health care costs and health care inflation may perhaps be the biggest reason for large budget deficits.

7) Fixing Social Security is relatively easy, by changing the index used for cost-of-living adjustments and raising the retirement age. Health care costs are another issue, however. Here, setting up a Bipartisan Commission to deal with this issue would be advisable.

8) Possible alarm over nothing with the Federal Reserve absorbing the bulk of the increase in Treasury issues in a slack economy where inflationary pressure will be slow to develop.

Whatever actions might be possible, the looming federal government deficit and debt problems need attention and the sooner the better. No nation can run unlimited federal budget deficits and get through large debt burdens without economic pain and adjustments. Actions to forestall and circumvent a federal government debt crisis before it happens would be well-advised.

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The Debt Outlook and Implications for Policy

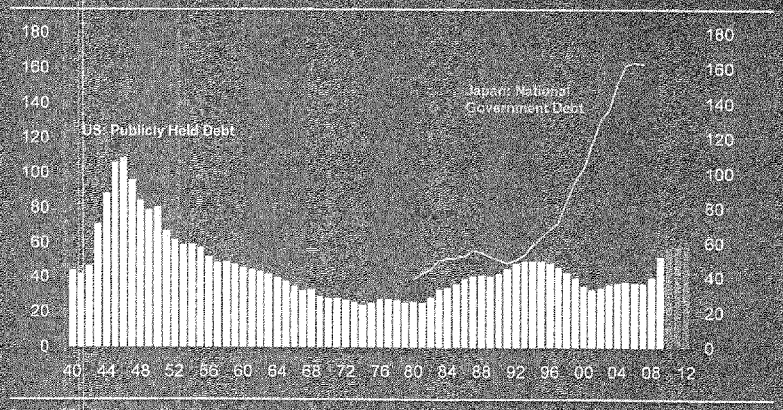
Senate Budget Committee

Richard Berner
Chief U.S. Economist
Co-Head, Global Economics
January 15, 2008

For important disclosures, refer to the Disclosures Section, located at the end of this report.

Does the Debt Buildup Threaten US Creditworthiness?

Percent of GDP



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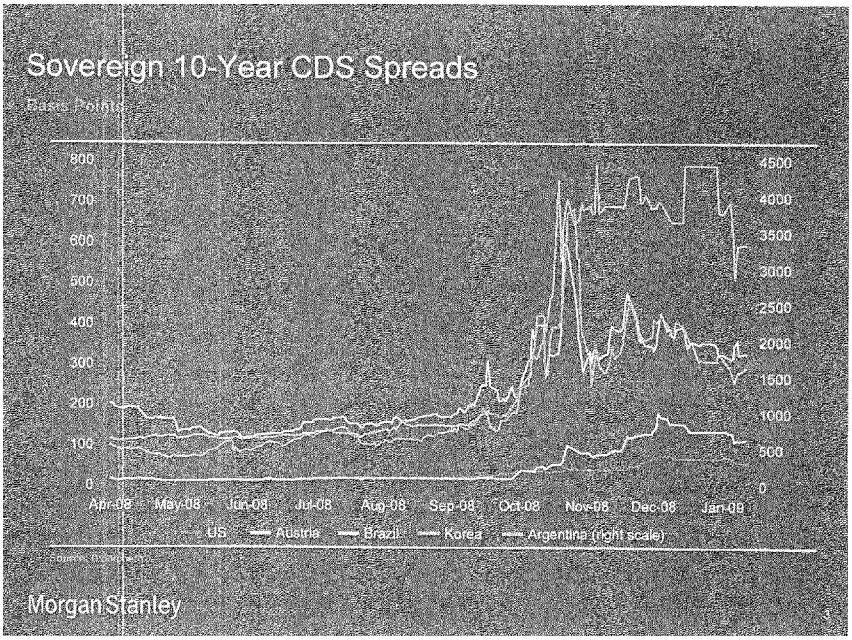
Sovereign 10-Year CDS Spreads
Basis Points
800
700
600
500
400
300
200
100
0
4500
4000
3500
3000
2500
2000
1500
1000
500
0
Apr-08
May-08
Jun-08
Jul-08
Aug-08
Sep-08
Oct-08
Nov-08
Dec-08
Jan-09
US
Austria
Brazil
Korea
Argentina (right scale)
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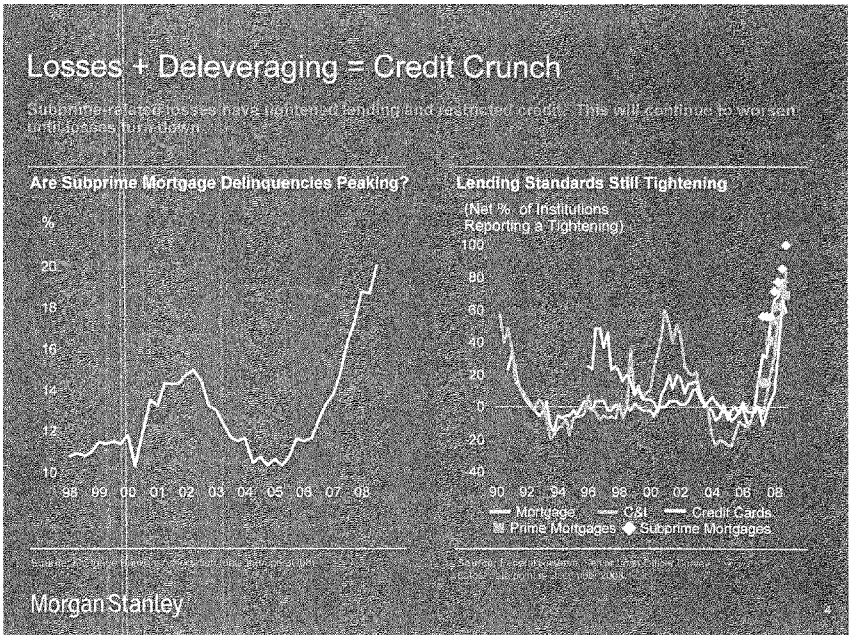
Losses + Deleveraging = Credit Crunch
Subprime-related losses have tightened lending and restricted credit. This will continue to worsen until losses turn down.
Are Subprime Mortgage Delinquencies Peaking?
%
20
18
16
14
12
10
98 99 00 01 02 03 04 05 06 07 08
Lending Standards Still Tightening
(Net % of Institutions Reporting a Tightening)
100
80
60
40
20
0
-20
-40
90 92 94 96 98 00 02 04 06 08
Mortgage
C&I
Credit Cards
Prime Mortgages
Subprime Mortgages
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US Expected Cumulative Loss Summary: Large Cap Banks, Total Banking Industry

As of 3Q08 in $ mil.

	Cumulative Loss Assumptions			Total Bank – Est. Cum. Loss ($ bil.)			Total Financial System – Est. Cum. Loss ($ bil.)		
Loans	**Base**	**Bear**	**Liquid-ation**	**Base**	**Bear**	**Liquid-ation**	**Base**	**Bear**	**Liquid-ation**
Subprime First Lien	25%	30%	45%	28	34	51	203	243	365
Alt-A First Lien	15%	20%	30%	16	20	29	105	140	211
Conventional First Lien	1%	2%	5%	7	11	38	62	94	312
Neg Am First Lien	25%	30%	40%	45	54	71	70	84	111
Other First Lien (Jumbo)	3%	4%	7%	3	7	15	45	53	105
1st Lien Mortgage	8%	9%	15%	101	125	202	485	613	1,103
Subprime Second Lien	40%	50%	60%	33	41	50	48	60	72
Prime Second Lien	15%	20%	30%	103	137	206	149	199	298
2nd Lien Mortgage	18%	23%	33%	136	178	256	197	259	370
Card	8%	10%	12%	30	38	45	78	98	117
Other Consumer	10%	12%	14%	62	75	87	160	192	224
Consumer Credit	9%	11%	13%	92	112	132	238	290	341
C&I Lending	5%	6%	7%	81	97	113	160	193	225
Resi Construction	35%	60%	70%	46	79	92	108	185	216
Other Construction	10%	11%	12%	42	47	51	99	109	119
Other CRE	6%	8%	10%	73	97	122	171	228	285
Total CRE	9%	13%	18%	161	223	264	378	522	620
Total Cum. Losses	7%	9%	13%	571	738	988	1,469	1,876	2,660

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Chairman CONRAD. I am thinking about whether I should say "thank you." That is pretty sobering testimony, but it is really what I anticipated because we had a chance to review your paper from 2004, and we will come back to the questioning round after we

hear from Dr. Holtz-Eakin, who I again want to welcome back to this hearing room and again thank him for his service to the country. You know, those of us in politics rarely admit we were wrong, but I was wrong about Dr. Holtz-Eakin. I did not support his confirmation, which I now regret because he proved himself to be a consummate professional at CBO. And, again, we welcome you back, Dr. Holtz-Eakin.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PH.D., PRESIDENT, DHE CONSULTING, LLC

Mr. HOLTZ-EAKIN. Well, Mr. Chairman, thank you for the opportunity to be here again, and it is great to be back with the Budget Committee, Senator Gregg, Senator Wyden. Thanks for the chance to talk today.

I have said many times that you cannot say too frequently and too apocalyptically describe the long-term budget outlook of the United States. But having just listened to the two previous witnesses, I am not sure I want to repeat all the things that I have written down in my testimony. So let me just make a couple of brief points.

The starting point for this discussion has to be the long-term budget outlook, which you mentioned in your opening remarks, and the driving force in that long-term budget outlook—the spiraling up of the debt-to-GDP ratio—is driven by the spending in Federal programs. And there is no sensible and feasible way to tax your way out of that problem, and the notion that somehow you can resort to tax increases to solve this is simply misplaced. We have to recognize that it is a spending problem and recognize that, indeed, this is a threat to the United States. And it has been there for a while. We held hearings on it, and you are familiar with the basic problem.

It carries with it costs, some of which I think are pretty readily understood; others I think have missed recognition. Obviously, the more debt you have outstanding and the interest costs of servicing that debt limits flexibility in times of emergencies, such as the times we find ourselves right now. We have less flexibility than we otherwise would because of the debt outstanding.

It also has direct economic costs that I will not belabor but which are real. It reduces the saving in the United States, reduces the wealth accumulation. That translates directly into inability to have higher standards of living, higher real wages for our workers, hurts our ability to compete around the world—all things that we are cognizant are happening, but seem to be unwilling to go back to some of the root causes, which are the large spending programs and the deficit accumulation that comes with it.

And it also gets in the way of doing the very things we need to do. If you think back to recent discussions, independent of what you thought were the merits of various Social Security reform proposals a few years back, the transition costs, the large debt that one would have to incur to do those reforms, gets in the way of pursuing those reforms. The same is true for tax reforms that we recognize the need in the United States. It will be true for health care reforms, which are imperative in the United States.

The more debt we have outstanding, the less palatable those transition costs will be. It will be harder to do the things that everyone in this room knows we need to do. And those are characteristics that have been around for a while, and now we find ourselves in a situation where we are laying on top of that the imperatives of the near-term economic outlook and addressing it.

I want to just make the point that, you know, if we were to undertake a $1 trillion stimulus and increase the debt-to-GDP ratio by about 10 percentage points, if it was genuinely stimulus—by which I mean you turn it on and then turn it off, which is what stimulus is; that means cutting the spending back and raising the taxes; not to belabor the point, things that do not happen very easily in this town. If you undid it immediately, it would take 5 years of average economic growth to get you back to where you started in terms of debt to GDP. So you have to put on hold necessary major reforms for something like 5 years, and that is if you do it on a textbook basis and do not continue to run up the debt.

So this is a "high degree of difficulty" enterprise that is being discussed right now in the Congress, and I want to note that it will have implications for the ability to do other important reforms.

I think that it is important to echo the point that Dick Berner made, that there is a distinction in my mind between stimulus, fiscal policy of higher spending and lower taxes aimed at an industrial-style recession, and the financial market interventions to restore the functioning of credit markets and other things. I am focusing my remarks on the stimulus per se.

Any near-term increase in debt that comes from stimulus should be paired with a clear, as Dick put it, "exit strategy" that will convey that the Federal Government is going to put itself on track to deal with the debt increase. And that will provide some confidence to global capital markets that would not otherwise be there. It has been a perennial puzzle as to why any international investor who ca look at the long-term budget outlook remains so confident in the creditworthiness of the U.S. Government. There is no reason why we should continue to simply hope it continues on without changing. We should take steps to address it.

What does that mean for the near-term rise in debt that is likely to come with stimulus? I think you do not make your problems worse. So, No. 1, you should not put into a stimulus exercise new spending programs that are not going to go away. You have to be realistic about the outlook, and this is not the place for downpayments of large new spending programs that are not going to be offset somewhere. And, instead, you want to focus on things that do go away, and there is a long tradition of automatic stabilizers, things like unemployment insurance, food stamps, supplemental nutrition programs, which expand as the economy deteriorates, but then also contract automatically as it improves. And to the extent spending is in this exercise, that is a great place to concentrate it because you will get the exit strategy right automatically.

I think that it puts a premium on tax cuts because we really know that we have a spending problem. If we are going to do things quickly, doing them on the tax side makes sense to me. And getting high-quality ones, again, is the goal in that.

And I also think it suggests that you ought to, as part of this exit strategy, think about issues like reforms to spending programs that improve their transparency. I like the idea of making sure that the bill is posted prior to any passage. People can scrutinize it clearly, see where money is going, what tax cuts they are, what spending programs they are.

I like the idea of taking this opportunity to actually address basic problems in the budget process, notions of unrealistic baselines where we pretend that the Medicare program is going to automatically contract with draconian cuts to physicians. You know, we need to have an honest presentation of where we are with a level playing field between taxes and spending. We can come back and talk about that. I think that is something that ought to be part of this discussion—and, obviously, dealing with the entitlement programs. It has been the elephant in the room for years. It remains there. We do need to come to terms with them, but doing that in the context of a budget process that is more functional.

For example, it is a little thing, but I think it would send the right signal if the Congress passed the fiscal year 2009 appropriations bills and did the regular budget process in a timely fashion before it turned to this new exercise in writing checks, which, again, I just want to emphasize, are not without costs, and the sort of notion that somehow this is a costless exercise of $1 trillion is what I find troubling in a lot of the public discussion.

So I want to echo some of the comments of the witnesses before me about how important this issue is. The obvious need for long-term entitlement reform remains the paramount issue, and layering on top of it a poorly executed $1 trillion deficit over the next couple of years is something that I would find very troubling.

[The prepared statement of Mr. Holtz-Eakin follows:]

Testimony on:

"The Debt Outlook and its Implications for Policy"

Douglas Holtz-Eakin*

United States Senate
Committee on the Budget

January 15, 2009

*President, DHE Consulting LLC (dheconsulting@gmail.com). The views expressed here are strictly my own.

Mr. Chairman, Ranking Member Gregg and members of the Committee, I thank you for the privilege of appearing today to discuss the important issue of the federal debt. I would like to make three main points:

- Federal debt outstanding is a reflection of economic policy choices, especially the decision to enact and expand spending programs.
- The recent sharp rise in federal debt – and the likely further increase due to fiscal policies under consideration – is far from costless. This rise:
    - Reduces federal budgetary flexibility in the future,
    - Imposes lower standards of living on future workers and hinders U.S. competitiveness, and
    - Will likely prove an impediment to fundamental reforms of the tax code and entitlement spending programs.
- Any necessary sharp, near-term rise in federal debt should be paired with an explicit strategy to address the underlying forces driving up federal spending, thereby stabilizing and reducing the debt outstanding.

Determinants of Federal Debt

The Congressional Budget Office reports that at the conclusion of fiscal year 2008, federal debt in the hands of the public exceeded $5.8 trillion dollars, up from $4.8 trillion as recently as 2006. As a matter of accounting, federal debt outstanding is the cumulative amount by which federal outlays exceed federal revenues – generating annual budget deficits – and the interest costs on past debt. Thus, the rise in the federal debt outstanding *per se* is not a policy issue. Instead, debt outstanding is a reflection of underlying policies:

- The decision to spend, and
- The decision on when to tax.

The most important decision is the decision to enact spending programs. Federal spending programs consume and transfer economic resources. Once government decides to undertake $1 of federal spending, it must necessarily acquire control of $1 to finance that spending. For this reason, federal spending

is a straightforward and reasonable measure of the burden of the federal government.

Recent spending developments are illustrative. In 2008, federal spending totaled roughly $3 trillion dollars, or 20.9 percent of Gross Domestic Product (GDP). The Congressional Budget Office projects that without full funding of the costs of military operations overseas or new legislation, spending will rise to $3.5 trillion in 2009. At the same time, the federal debt in the hands of the public is projected to rise by $5.8 trillion to $7.2 trillion, or from 40.8 to 50.5 percent of GDP.

These recent spikes in new outlays are layered upon an already-bleak long-term outlook for federal spending. As documented in a series of *Long-Term Budget Outlook* reports by the CBO, if current demographic trends, health care spending growth, and federal mandatory program rules for Social Security, Medicare, and Medicaid are left unchanged, spending is projected to raise explosively in the future, and the federal debt accordingly to spiral beyond control.

Of course, federal debt need not necessarily rise with new spending programs. Again, that outcome is the result of decisions with respect to spending and tax policy. Lawmakers could choose to shift resources – reducing spending in other areas to accommodate new spending. There is little in the history of the federal budget that shows this strategy at play on a significant scale – overall spending rises even as new policy initiatives ranging from military operations to Medicare benefit enhancements to financial market stabilization are undertaken.

Finally, policymakers could prevent a rise in the debt by raising taxes, using the tax code to take command of the necessary resources to meet the spending needs. But the decision to borrow the necessary funds simply means

that the taxes are deferred, not avoided. As interest costs accrue and principal payments come due, taxes will have to rise to meet these obligations.[1]

In sum, rising federal debt has its roots in decisions to increase federal spending without offsetting reductions in other outlays and to defer the imposition of taxes to a later date. Fundamental changes to the outlook for federal debt cannot be achieved without fundamental changes to the foundations of budget policy.

The impact on financial markets is an important element of using debt to finance federal policies. In particular, the sale of Treasury instruments competes in a global marketplace with an enormous array of household, corporate, quasi-governmental, sub-federal government, and sovereign financial instruments. The availability of alternatives imposes a discipline on federal debt management – offerings must offer a sufficiently competitive combination of risk and return to attract the needed funds.

Investors assess such offerings by evaluating the risks of asset price declines or outright defaults. In both instances, the primary concern is that future new issuances of debt will be so large as to dramatically drive down prices or actually exceed the ability of the government to honor the debt contracts. Mechanically, investors can arrive at this conclusion only if they anticipate ever-rising spending beyond the ability or willingness of a government to impose the taxes to finance it.

A good metric for evaluating the risks is the ratio of federal debt in the hands of the public to GDP. Debt in the hands of the public measures the need by the Treasury to attract resources for spending not financed by taxes.[2] GDP is a broad measure of the capacity of the U.S. economy to generate income, and thus the pool of resources available to be taxed and either service or retire the debt.

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[1] Of course, spending could be cut to make room in the budget to pay interest or principal obligations.

[2] In contrast, the gross debt includes Treasury securities held by entities within the government.

Notice that tax cuts or spending increases – other things held constant – increase the debt and raise the ratio. However, to the extent that these policy changes are pro-growth, they also will increase GDP in the denominator. That is, the ratio captures both the benefits and the costs of debt-inducing policy changes.

Concern about the outlook for U.S. federal debt centers on the projected rise in federal spending over the next several decades. For example, the most recent CBO long-term outlook projects a rise of 15 percentage points in the debt-to-GDP ratio between 2009 and 2050.[3] This occurs despite the fact that taxes are assumed to be raised from 18.7 to an unprecedented 23.5 percent of GDP, and the anti-growth impacts of this 25 percent expansion of the tax share are excluded from the analysis. In contrast, with different revenue assumptions – taxes held to a more modest rise to 19.4 percent – debt explodes by 256 percentage points over this horizon.

At what point do participants in global capital markets suffer an erosion of their confidence in the future viability of U.S. securities? Unfortunately, there is no magic "bright line" numerical cutoff for the debt-to-GDP ratio that signals a safe harbor below or threat above. Instead, the fundamental evaluation is whether global capital markets believe in the fundamental rough balance of the future of budgetary policies.

Costs of Federal Debt

As noted earlier, spending measures the basic burden of the federal government.[4] Federal debt shifts the financing of that burden from the present to the future. In doing so, it imposes additional costs.

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[3] This analysis pre-dates, and thus does not incorporate, the recent sharp receipts decline, spending increase, and rise in federal debt.

[4] A more extensive discussion of this is contained in CBO Director Douglas Holtz-Eakin, "The Economic Costs of Long-Term Federal Obligations," Committee on the Budget United States Senate February 16, 2005.

To begin, larger outstanding federal debt necessarily means that the federal budget will carry with it larger interest costs. These mandatory outlays will cut into the ability of the Congress to manage the composition of overall spending, reduce flexibility, and impair the ability of future Congresses to address unexpected budgetary challenges.

Because debt shifts financing of outlays from the present to the future, it also shifts the distortions of taxation to the future as well. With higher taxes inevitably come interference with decisions on schooling and skills acquisition, occupation, work, hours, entrepreneurship, saving, portfolio allocations, and the many other aspects of economic life. If debt serves to keep taxes lower on average by shifting the burden of taxes to offset a temporary spike in spending, average efficiency is improved. In contrast, if debt defers taxes on permanently high or rising spending, the damage to the economy is higher on average and focused on the younger generations.

On average, federal borrowing lowers national saving, and thus cuts into the national wealth accumulation that finances a higher standard of living for the future. In this way, a debt is burden on capital accumulation, productivity growth, and the real compensation of workers in the future. In a global economy, these effects also diminish the ability of the United States to compete effectively on open, world markets and directly expose our firms to greater import and export competition.

Finally, a large, outstanding public debt likely raises a hurdle against much-needed fundamental reforms in the United States. Over the past decade, discussions of fundamental tax reform, Social Security reform, and health care reform have often foundered over the transition costs – necessarily financed by public borrowing – of reform proposals. To the extent that this remains true, higher near-term borrowing acts as a barrier to much-needed reforms in the U.S..

Principles for Debt Management in The Current Economic Climate

The fairly straightforward discussion of policy options for addressing the federal debt is clouded by the policy imperatives of responding to dramatic financial market distress and a sharp economic downturn. It is imperative that the federal budgetary response to these events be developed in the context of a strategy of budget process and policy changes to address the fundamental, long-run spending growth that feeds explosive debt. President-elect Obama is to be applauded for his recognition of this facet of challenge, and I implore the Congress to place this at the center of its deliberations.

How does "stimulus" fit into the debt discussion? In principle, stimulus represents a one-time increase in the debt as taxes are cut and/or spending is increased temporarily. In the current context, discussions center around a stimulus effort that would raise the debt-to-GDP ratio by about 10 percentage points. If stimulus works well – again, in principle – GDP would rise more (or fall less) than otherwise, muting the increase in the debt-to-GDP burden. Finally, when the temporary stimulus is withdrawn, further rises in debt abate.

What are the consequences of this exercise? Assuming that the basic growth rate of the economy is roughly 2.5 percent, a one-time rise in the debt-to-GDP ratio of 10 percent can be offset over five years of average growth. Put differently, one price of the stimulus exercise is that fundamental changes to the level of spending and taxes (unless paired) have to be put on hold for five years.

Clearly, in addition to a large financial and borrowing cost, stimulus carries with it a potentially large costs in terms of restrictions on future policies. In light of this, it seems sensible to evaluate stimulus in these terms – in addition to the obvious need to help an economy that is clearly struggling and workers who are facing tough times and have lost jobs.

A first principle, then, is that the stimulus effort should avoid new policies that creating new spending programs. From a debt perspective, these types of programs would exacerbate the underlying spending growth that is feeding

unsustainable debt projections. From a political-economy perspective, bringing to a stimulus exercise new programs about which there is little consensus likely would (and should) prolong debate and slow implementation.

Finally, from an economic growth perspective, to the extent that there are productivity-enhancing investments that will provide economic returns in excess of their financing costs, then these are the types of activities that the federal government should undertake regardless of current economic conditions. The empirical regularity that the large majority of these kinds of federal spending proposals do not make the grade outside of times of economic duress casts doubt on their claim to pro-growth status. Moreover, it would make sense to find budgetary resources for these investments by reducing spending elsewhere. To make the point starkly: if infrastructure investments will help the economy, in general, and the blue-collar, middle class, in particular, why should these not be financed by reductions in the entitlement benefits of the affluent?

A corollary to avoiding permanent new spending is that spending increases should be concentrated in fortifying the "automatic stabilizers." Programs like unemployment insurance benefits, food stamps (Supplemental Nutrition Assistance Program) and so forth automatically increase in scale during economic duress as more Americans qualify for benefits. These kinds of programs offer two advantages. First, they expand upon need, are tuned to the economic conditions on the ground, and minimize the traditional risk of arriving too late to be effective. Second, they automatically shrink as conditions improve – guaranteeing their temporary nature. Neither of these advantages are present with new spending programs, even seemingly-modest "down payments" on future programs.

A second principle is that the focus should be on tax reductions. Moreover, because temporary tax reductions are largely saved, any tax relief should be as long-term as possible, reduce taxes on pro-growth activities, and eliminate uncertainty about the future of tax policy. To the extent that these tax changes are steps toward a fundamental reform, the additional debt would

implicitly finance these transition costs as well. For example, the U.S. code continues to impose a double tax on dividend income, the corporation income tax rate places U.S. firms at a competitive disadvantage, and the year-to-year uncertainty of the research and experimentation tax credit undermines its economic intent. Each could be rectified in the near-term as steps toward a more integrated and efficient tax code. Similarly, the payroll tax is widely recognized as imposing a burden on workers and interferes with labor market incentives at a time when getting people to work is a priority. Reducing the payroll tax would raise issues regarding the structure and finance of retirement programs, but these issues must be resolved in any event.

A third principle is that the effort should provide clear signals to financial markets. This should occur in three ways. First, the programs should be transparent and document the economic impacts. I favor the notion that earmarks should be banned from such legislation, and that the legislation itself should be available electronically for public scrutiny for a substantial period prior to vote. The market could easily assess, then, the economic character of the policies.

Second, markets should be able to assess what is being gained for such a significant commitment of federal funds, and its economic impact. I applaud the recent publication by Jared Bernstein and Christina Romer of their analysis of a prototype stimulus. One may or may not agree with the numbers, but it shows the path of the economy without stimulus, the path with stimulus, and the benefits of stimulus. It has the ingredients needed to assess the net benefits.

Thirdly, I believe that it is important that the effort convey to markets a clear path to stabilizing and reducing the debt burden. It would be useful if any stimulus legislation itself contained provisions that ensured a reduction in future debt as the economy improved. Moreover, if the effort is nested between timely completion of FY 2009 appropriations and imposition of improved spending controls, the market may reward a strengthening of overall budgetary integrity.

Thank you again for the opportunity to appear today. I look forward to your questions.

Chairman CONRAD. Thank you. Thank you for your thoughtful testimony, Dr. Holtz-Eakin, and, again, welcome back.

Dr. Sinai, I would like to go back to that paper that you wrote, co-wrote in 2004. In that paper you warned of the risk of a fundamental shift in market expectations and the loss of confidence that could occur when large, unsustainable budget deficits are projected. You stated, "It is impossible to know when this type of fundamental shift in market expectations might occur." But you noted that, "If such a shift does occur, the consequences of the resulting

fiscal and financial disarray would be substantially more negative than the standard projections of sustained budget deficits would predict."

That really caught my attention because, as I have discussed with economists of every philosophical stripe in these recent weeks and months, it has come back to me over and over that we are in uncharted territory here, that nobody can be certain of what the reaction might be once recovery is underway and all of these treasuries have to be rolled over, and the United States may find itself in an extremely difficult situation with respect to financing this debt.

Could you help this Committee better understand what you see as the potential risk? What are the implications of that risk?

Mr. SINAI. Well, I think in the last of your comments, you really have it right because we will have a recovery in the U.S. economy and in the world economy probably in 2010 of some sort. And then if you put yourself at that time and look at—as Doug reminds us, once you build in through increased deficits the debt that goes with it, the deficits might come down some, but the debt is still there and it keeps accumulating. And depending on the pace of growth of GDP, you have an increasing burden, along with the interest charges on it. And in a recovery, interest rates would go up, so the interest charges on that debt would be bigger. And if you were to step back and just play a hypothetical game, what would the world look like, you would look at a country with—for the G–7 countries, perhaps ex Japan, the most exposed government financial situation of any in the history of mankind with regards to deficits and debt to GDP and the interest charges on that debt, a country hamstrung for this reason and unable to spend the money—because it is not there—to do some of the major societal things we need to do. Just no leeway. We probably would have very little foreign exchange. We do not have much foreign exchange surplus now.

Around the world, you would probably look at a country like China right now with huge amounts of foreign exchange, so far, so far as we can tell, doing a lot of good things on policy, probably going to have a recession but nothing like what is going on in other countries. Now the third largest country by the bean counters, ours as well, in the world, dominating Asia, and looking ahead asking if I am an investor, where do I put my money.

Now, many of these countries have sovereign wealth funds. Those countries that have developed huge foreign exchange surpluses over the years, and because of our current account deficits, we have not. And so they are going to have to invest those moneys, and they will look around the world, and we will have a much greater supply of treasuries out there in the market. Where will they invest? Their charge is to get competitive returns. Well, even if the Federal Reserve buys all our treasuries and keeps interest rates low—those returns will be very low—they will not be there. We will have to buy it. And if we have to buy it in this country, then we have to save to buy it. We cannot spend. And if we do not buy it, interest rates go up. The stock market goes down. And that reverberates. Getting to how does this work, it reverberates back on hamstringing the economy. Financial institutions do poorly on situations of rising interest rates and falling stock prices. Look at

where we are now. Balance sheets of financial institutions shrink. Our financial system, however it looks at that point, will be compromised.

In the U.S., if you step back and look at it, in that situation it is a bit of a caricature comment. We will look like a banana republic.

Chairman CONRAD. You know, I wish, Dr. Sinai, that every colleague of ours in the House and the Senate, and I wish every American could hear the description you just gave, because what you have just done is connect the dots for people. What happens if certain things occur? What is the effect on the economy?

You know, I guess one of my greatest frustrations is around here people look at all this, many of my colleagues—I just get the sense that this is just numbers on a page and it is not connected much to real people's lives; and those of us who raise these concerns are almost seen as somehow in some other-worldly state in which we are not really connected to real people's lives.

This is connected to real people's lives. This is not numbers on a page. And all those people—I have colleagues say to me, "You know, Kent, when you talk about being concerned about these deficits and debt, you do not seem to be concerned about what is happening to that guy out there that is losing his job and cannot make the car payment, cannot make the house payment."

And there is a disconnect—I really feel it very strongly here—between what we are doing as a country here in terms of our fiscal policy and our monetary policy and how it affects real people's lives. These things are directly connected.

If anybody thinks this stuff is just numbers on a page, they have—if you are right, Dr. Sinai, if you are right, Dr. Berner, if you are right, Dr. Holtz-Eakin, they are in for one hell of a surprise. And it is not going to be a happy one.

Let me just go quickly. In the Outlook section of the Washington Post this last weekend, there was an article written by a Greg Ip of the Economist magazine—I do not know if you saw it—talking about the issue of U.S. Federal debt. And after discussing other countries that have defaulted, the article stated, "...it would be ridiculous to put the United States in the same company as Russia, much less Zimbabwe. Nonetheless, even if Washington never defaults, it can still suffer if questions about its ability to repay affect its creditworthiness and thus its cost of borrowing."

He went on to say and conclude, "The best way to keep those chances remote"—that is, of a default or the harmful effects of doubts about the creditworthiness of the United States—"is for policymakers to vow to get the deficit down once the recession is over—and mean it."

I would ask each of you, what is your reaction? Do you agree with that assessment? Or what is your reaction, Dr. Berner?

Mr. BERNER. Thank you, Mr. Chairman. I do agree with that assessment, and I would just enunciate principles that I think are pretty familiar to you that we need to tell voters we have a serious fiscal problem and a limited time in which to deal with it. And in that regard, your recommendation with Senator Gregg for a bipartisan fiscal task force I think could be an important platform for making that known.

You must elevate the issue and make it tangible. You must commit to realistic goals and a rough outline and the game plan needed. A promise is one thing, but I think people want to see some concrete and specific ideas of where we are headed.

I share Doug's concern that the budget process is broken. We need to fix it. We need to work with the administration to break down the compartmentalized decisionmaking that seems to hold nobody accountable in the budget process.

I agree with Doug it would be great if we could get bills passed, if we could show that the budget process is once again working. We have to be honest about the numbers that we use instead of using numbers that people can question.

The discipline in PAYGO I think would be an important thing to reinstate. I think people have to be willing to put all options on the table, and last but not least, you know, if there are, let us hope, some revenue windfalls, do not spend them. If there are savings from budgeted programs, let us not look at that as a kitty into which we can dip. We should save those and use them to make a credible commitment to really bring the debt and the deficit down.

Chairman CONRAD. Thank you.

Dr. Sinai, what do you say about Mr. Ip from the Economist, his assessment?

Mr. SINAI. I think balancing the budget in some sense over the business cycle is a good framework. Business cycle downturns can last a long time, a short time. When you are on an upswing, you will get a lot of surprises and revenues that will make life easy. The discipline in spending that Doug talks about throughout ups and downs in the business cycle is absolutely essential. That has been missing for years here. I think it is going to be missing even in this economic recovery program in the hurry-up fashion and the panic over what is, arguably, a very bad economic and financial situation. It is almost as if no one is asking how much anything is costing. The moneys are being spent by the Government at the taxpayer's expense, without as much thought as I would like to see go into it with regard to the longer-run issues and by-product of what we have to do in the near term.

So the bipartisan commission one setting a fiscal framework in the new world that the U.S. lives in, globalized world, makes some sense. And thinking of a balanced budget framework over the course of time, and in advance—and I do not have detailed answers other than PAYGO, but in advance, building in triggers that would reverse stimulus as certain conditions arose and having that part of legislation so that Congress gets stuck, as they did when we did PAYGO; they had no choice, is a way to go.

Chairman CONRAD. If I could just say this: I am a strong advocate of PAYGO, but to me this is way beyond what PAYGO can do. PAYGO is a tool, certainly an imperfect one, as Senator Gregg has reminded us of many times. But it is a tool. But what to me is required here are policy changes. We have entitlement programs the promises of which simply cannot be kept. And we have a revenue system that, too, I think is broken, badly out of date, largely written 50 years ago, and we are in a totally different world. We have a tax system that was written when the United States was domi-

nant, and we did not have to worry about our international competitive position. Now we do.

If one were going to write a tax system in light of the United States being in a tough, competitive circumstance, we certainly would not write this one.

Dr. Holtz-Eakin, what is your reaction on this notion that we have to—once we get through this current downturn, we have to pivot and get serious about the long-term imbalances?

Mr. HOLTZ-EAKIN. I think it is dead on the mark. But as you do the pivot, I—you know, Greg Ip suggested balance the budget. I would suggest that, you know, the first thing, find ways to turn off the spending you have turned on, whether that is sunsets or the structure of the programs themselves; and, second, you pivot to reducing Federal spending in the long term. That is the problem. And balancing the budget is not the same thing as addressing the long-term spending problems, so you have to find a pivot that says that if you are going to put something on the books that is longer in duration than, say, a year, it has to come at the expense of these commitments for long-term entitlement spending. And that is saying something that is arithmetically easy and politically, you know, as difficult as you can imagine. I know that. But that is the only way you will convey to financial markets that you are not going to allow the debt to continue to rise, and that is the only way, as a result, to build confidence as opposed to simply try to hold onto what we have.

Chairman CONRAD. Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman, and I thank the panel for being so blunt and stark, because I think we need to be blunt and stark.

I noticed Dr. Berner, that you suggested that the stimulus package should have at its core not spending or tax cuts, but a restructuring of mortgages. Is that what you are proposing to get to the bottom-line real estate issue and also a restructuring of the bad debt structure of our banking system? Is that correct?

Mr. BERNER. Senator Gregg, my proposal would be to help clean up the balance sheets of our financial institutions. They need to be able to raise private capital and get back on their feet. To some extent, that is going to involve liquidating some of the institutions that are insolvent, without any question. And the sooner we can get on with that process, which is proceeding very, very slowly, the better off we will be in fixing the financial crisis and the recession that has resulted from it.

Senator GREGG. How do you suggest you liquidate these institutions?

Mr. BERNER. Well, we have a well-established procedure set up by the FDIC. Prompt corrective action under the law that was passed back in the early 1990's for liquidating institutions that are troubled really has, I think, given us a clear road map to do that.

The problem with what we are doing right now is injecting capital from the taxpayer into institutions. Without making strenuous efforts to clean up their balance sheets, the risk is that that capital will disappear in further losses and further impair our financial system and those institutions.

So our financial regulators and you and Congress I think need to be more aggressive about ring fencing the bad assets and about using the moneys that have already been allocated for that purpose to separate them from banks' balance sheets and let the chips fall where they may.

Senator GREGG. I would be interested in the panel's views regarding something Dr. Sinai talked about—the deflationary future here. There is a lot of talk that what the Fed is trying to do is actively inflate the money supply. And it obviously is not taking hold because the economy is contracting so quickly.

Do you think the Fed should be pushing an inflationary policy where they basically try to inflate our way out of this?

Mr. SINAI. Our Federal Reserve is in a very tough position. It has two goals: sustaining the economy and price stability. And on the economic side, it is a dire situation. And the credit function has collapsed, the credit function is not working within the credit system and outside, to those who would borrow the money and spend.

So I think essentially what the Federal Reserve is evolving toward is not only being a lender of last resort to banks—then it became a lender of last resort to primary dealers—it now is moving toward becoming a lender of last resort to the private sector, because the private sector is not getting credit. And that is in line with the growth objective of the Federal Reserve, and for the moment, putting aside inflation as a concern—because we have more deflation right now than we have inflation—it seems to be a proper—this part of the shifting of the weight on what they are doing seems to be proper.

This is uncharted territory. I think without the actions the Federal Reserve has taken with regard to funding the commercial paper market through an entity and funding the mortgage-backed securities market buying the debt of GSEs, and soon the $500 billion levered—$200 billion levered program, $20 billion of taxpayer money from TARP, to the Fed, the bank. It is like a private sector bank. It is going to lend in the private sector, 3-year terms, make good loans. They will probably do a better job at it than many of our banks have done and will not take quite the same risk. So I am in favor of that.

And I am in favor of the Federal Reserve extending what I call the American-style quantitative easing, because they cannot cut rates anymore, to buying treasuries in order to keep mortgage rates low and because somebody is going to have to buy treasuries someday when our Treasury issues all this debt.

There is a long-term inflationary risk, and certainly there is a moral hazard issue with regard to this, but moral hazard and the long-term inflationary risk pales in comparison to the really awful economic and financial situation we see now in the world. And I think we have to give them leeway on this experiment.

It is long-run inflationary. It is a central bank in a debtor country doing incredible things to inflate their way out of the problem. It is the political system, the Government, in bed with the central bank and vice versa doing that, in the private sector doing deals to—and taking bad stuff on the balance sheet of the Fed.

I do not know that there is another choice than this in the situation. I was not there when all of this was concocted up. There are

always other choices. But I think we have to be supportive given the circumstances we face today of this move—moves by the Fed.

Mr. HOLTZ-EAKIN. I just want to echo the closing part of that, which is it is basically an inflationary stance. It is an aggressively inflationary stance. The Fed is targeting, has talked about targeting different maturities of treasury securities. Those are being issued because we are running deficits. In the old days, they would have called this "monetizing" the deficit. They are printing money to pay the Government's bills, and that is what they are doing. And it comes with a moral hazard. And I would commend to anyone interested to read Robert Samuelson's recent book, "The Great Inflation and Its Aftermath," which documents how the kinds of things that we are talking about today—fiscal stimulus, interventions to reduce unemployment, having empathy for people who genuinely are struggling in hard times, but not thinking about the consequences of repeatedly promising to people that you can take care of them as a Government when, in fact, you cannot.

What it led to was tremendous inflation in the United States, sub-par economic performance, no real improvement in unemployment, and the need for a wrenching 1982 recession in order to put things back in order.

So the idea that we are doing these things one time because circumstances dictate it, I understand that argument. But the next time things start to look even a little wobbly, you will hear the same arguments again. And to do it on a regular basis has great risk.

Senator GREGG. Thank you.

Did you want to add something?

Mr. BERNER. Senator, I would just add one more thing to that, and one of the things that has not been discussed here is once we finish cleaning up our financial system—and that is probably going to take several years to do—the need for a new financial architecture, for a new financial regulatory scheme is pressing. And, you know, as the new administration comes in, a lot of people in the administration have thought about it. I am sure you both have, you all have. That is a pressing need so that we never get back in a situation like this one again and putting at risk the kinds of things that we are now putting at risk with the extraordinary policy measures that are now being taken.

That will enable us to build shock absorbers into the system that will prevent us from—or limit the risk that w will have a situation like this once again.

Mr. SINAI. This is an extraordinary short-run situation. The Federal Reserve does not have an exit plan for what they are doing. They understand the chances they are taking, and I think they have made the calculations it is worth taking those chances when you array the loss of jobs versus the moral hazard and deflation versus inflation risk. And they have made—most of them have made their judgment, which I support. But I do not want to lose millions of jobs. I will take a chance on moral hazard, and I will take a near-term—I will take a risk on inflation and come back to visit it later on.

You know, human beings, decisionmakers, have only so much time, and they do not have an exit plan. Chairman Bernanke

talked about one the other day, which was very, very superficial, very, very light. We do not have an exit plan on an Economic Recovery Plan. We are focused on economic recovery. We are focused on helping out the financial system. The global situation, there is almost no time and space to think about how one will exit from this for the Federal Government, what you were talking about in terms of the long-run issues.

I think exit plans have to be part of the initial discussions of the short-run actions we have to take for emergency situations. And I would simply encourage you to do what you are doing with regard to both our central bank and the budgetary situation, that we think about the exit plans, and to the extent possible, plan what we would do under certain conditions so we can exit from the way we have put not only our Government at risk from a credit point of view, but the institution of central banking in this country at risk.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. I want to commend you and Senator Gregg on putting together this panel, because I think it is doing exactly what you are talking about, is to take these issues which so often just look like charts and graphs and cold numbers, and then bring them down to the real world. And I also share your view about the importance of these three witnesses in particular.

My rule has always been in this town, when Doug Holtz-Eakin has something to write about and something to say, I pay attention. And this has been an excellent panel, and I appreciate all three of you and your comments.

Mr. Berner, I want to turn to you particularly because of your recommendations with respect to banking. You note in your testimony that banks will start lending when they feel secure about their balance sheets, and the next step must be an aggressive effort to fix the banks' balance sheets.

Here is the way it is coming to Members of the U.S. Senate, really on a daily basis. It happened to me yesterday. Folks running small businesses come to us and say: You all gave $700 billion—first installment $350 billion, perhaps the vote tonight on $350 million more—to these financial institutions. I am creditworthy. I have never done anything wrong. I cannot get a loan.

Some of them are in bridge funding now and really scary, scary things that go right to the heart of being able to keep their doors open. In fact, probably the most ominous sign with respect to the credit freeze is even SBA loans have dropped dramatically, and these are guaranteed loans. These are loans where the Government is saying, look, we are going to be there to give you that extra measure of security.

Now, Senator Conrad and I, as part of our other activities here in the Senate, will be looking at some of these issues on the Finance Committee. And one provision that has been under discussion is a retroactive extension of the net operating loss rules that would also go to financial institutions. And I am thinking about the prospect of my future conversations with these small businesses going—and my guess is these are going to be fairly spirited exchanges that will, in effect: "Ron, excuse me, you gave them $350

billion the first round; they did not lend to us. Now you are talking about giving them extra tax breaks on top of that to claim losses, and we still do not have any assurance of actual loans being made to us and other small businesses?" And my guess is those conversations will be punctuated by some words that we are not going to repeat in public hearings.

So my first question to you is: Is there any sensible way—and I characterize that kind of sensible because I can think of a bunch of ways that would not make sense—to in some way connect institutions that get money, that claim these net operating loss incentives, to their actually making loans? In other words, you spend a lot of time with markets. We are pro-growth Democrats. We are committed to the ability of our markets to recover. We have also got to explain when all this money is shoveled out the door that in some way it is connected to the incredible angst and fear they have now where they cannot get money.

So my question is: Give us your thoughts about sensible ways in which getting this money, the tax incentives, actually be connected to getting the money into the hands of these small business people.

Mr. BERNER. Thanks, Senator, for your question. I mentioned, besides a program to help clean up banks' balance sheets—and that is going to require discipline on the part of the institutions themselves and from the Congress and from our regulatory officials. But one of the things I also mentioned was foreclosure mitigation. Foreclosure mitigation is a huge problem. I am sure you saw that foreclosures rose—started 88 percent last year, and it is something that is tearing at the fabric of American society. And I think that we have made some efforts to mitigate foreclosures. The efforts need to be a lot more aggressive, and I am sure will be in the future.

But there is no question in my mind that having a sensible program of foreclosure mitigation that shares the losses among the borrowers, the lenders, and to some extent the taxpayer, if that is needed to make the process work, is going to be something that helps free up our capital markets.

Senator WYDEN. But connect that to the small business process of their getting money.

Mr. BERNER. Sure.

Senator WYDEN. I think your idea, by the way, is a sensible one, and the Obama administration, to its credit—Senator Conrad and I have been hearing encouraging news on this point—wants to do that, and I think there will be bipartisan support for it. Connect that to this Main Street business that has been creditworthy, that has never once by any of the traditional standards done anything to warrant cutting off their credit. How will they get credit out of these next steps that could be adopted as part of TARP, as part of tax reform, the issues we are dealing with here.

Mr. BERNER. Right. That is the next step, because if we have a sensible plan for foreclosure mitigation, together with the steps that we have already taken to promote market functioning that the Fed has taken, which have started, only started to restore the functioning of financial markets. Then we can start the credit process going again and have lenders lend again.

Remember, there has to be a sequencing involved in getting the credit markets started. We have had some progress in funding markets, so-called short-term money markets. The unsecured interbank lending markets are starting to improve thanks to the efforts of the Fed and other central banks who have been very aggressive in providing both liquidity and financing facilities to the financial markets.

Allen mentioned the Commercial Paper Funding Facility, which has been very constructive and instrumental in that regard. Those are the first steps of the process. The next step, if we can start slowing down the foreclosures and slowing down the imbalance between supply and demand in the housing industry, that will start to stem the losses and combined with an effective program, I think, to clean up bank balance sheets. And remember, the foreclosure mitigation itself involves an effort to do that because you are taking the troubled loan off the books of the lending institution.

Senator WYDEN. I want to ask one other——

Mr. BERNER. That is—excuse me, Senator, that is going to restart the credit markets.

Senator WYDEN. I want to ask one other question. Respectfully, I just do not think there is enough time for all of this sequencing. My guess is I am going to go back to my office, and I am going to have another call on my desk from another small business asking me to call their lender and for me, in effect, to tell them, gosh, we are going to have this process, and it is going to start with foreclosure mitigation, and then we are going to go this and that, and maybe sometime, some way, somehow there is going to be help for you.

I just say respectfully I hope that you and your colleagues who are the best in the business will come up with more aggressive, more immediate approaches. I want them to be sensible; but, again, to be shoveling all this money out the door, not having it lent to small businesses, looking at additional tax breaks, it does not pass the smell test to, in effect, not have some bold new approaches.

One last question——

Chairman CONRAD. Could I just interrupt on that point, Senator? I just came from North Dakota. I have a big event every year I call "Marketplace for Entrepreneurs." We had several thousand people there. We had Mark Zandi, the chief economist at Moody's, as the keynote speaker there this year. I tell you, I have heard in the last few weeks, and especially in this last day and a half at home, the concern that you are raising here over and over and over. People with a $2 million deal, people who have done tens of millions of dollars of development in the State very successfully, a $2 million deal, 40-percent equity, strong cash-flow, AAA tenant—no ability to get financing.

A guy with a $12 million credit line, never been late in a payment, never missed a payment. The bank calls up, pulls his credit line—not because of anything he has done, but because their capital is so impaired, they have to shut down credit lines to existing good customers. And this guy is in, you know, a strong business.

I tell you, this is of deep concern, the point that you are raising about the ripple effect extending from these major institutions out

on the Main Streets of cities and towns all across America. And, you know, I tell you, I came back very sobered after this set of conversations.

Mr. BERNER. Senator Wyden, Chairman Conrad, if I could just respond to that. I share your concern. In my testimony, I said that, you know, this financial crisis is not going to easily get fixed. It is going to require aggressive action and cooperation of the financial services industry without question.

When we look at the capital of financial institutions, I mentioned that what needs to be done is to clean up balance sheets so that lenders will have confidence that they can lend. That is something that your intervention can help. The NOL carryback does have a financial benefit in the sense that it will help raise tier one capital ratios. What investors care about most is the ability of institutions to raise capital on their own, to restart the lending process and to get them functioning again.

So I see the need for two things that are very important. One is balance sheet cleanup. That is not going to happen overnight. The Fed knows that. We know that. And that is why the Fed is instituting—and I recommended that other asset classes like the municipal bond market, the commercial mortgage-backed securities market also be—that we use financing facilities for those markets in the short run to break the back of the credit crunch and to start the flow of credit to the small business people that you are worried about once again.

But to fix this problem, we need balance sheet cleanup, we need a new regulatory architecture, and we need to set our financial institutions back on the right course after having been on the wrong course for several years.

Senator WYDEN. Market economics has always been about chicken-and-egg. You make investment decisions, and if they are the right ones, promising things happen and the markets get better, and then there are more investment decisions that make sense all across the country every day.

But balance sheet cleanup to the people that Chairman Conrad heard from in North Dakota and that are calling me on a daily basis does not really resonate in a way that leaves them feeling that their Government is moving boldly. What they would like us to do in a lot of respects is almost sort of pretend that we can run financial institutions here and we can adopt all kinds of rules and pretty much micromanage everything that goes on at Morgan Stanley and the like.

I am not suggesting that is the way to go here, but I am saying that we need people like yourself and the most influential people in the field to figure out bolder, more aggressive, more immediate ways to help these small businesses, and particularly if additional money is going to be made available, which I believe will happen, and some way to connect that to immediate changes that happen on Main Street—not changes that are down the road when the balance sheets get corrected.

Mr. BERNER. Right.

Senator WYDEN. But changes that happen very quickly after that legislation is passed. Let me ask you about one—excuse me. One of your colleagues——

Mr. SINAI. Senator, the banks will never put that money out in the timeframe that you want to the people who you are talking to. They have bad balance sheets. They got themselves in a position with bad balance sheets. They devised the financial instruments, the so-called toxic securities, that were sold to lots of investors. It toppled when the real estate boom and bubble burst.

We do not need to clean up the balance sheets of the existing financial institutions that have, to a certain extent, got us where we are at. They need us to clean up their balance sheets to live and survive. What we need are new banks with clean balance sheets who have capital, who can go lend to the people you are talking about who are worthy borrowers and not to make the mistakes that Wall Street made and the road that Wall Street took us down in the last 8 to 10 years.

It is not in their interest when they get the funds, and as a shareholder of one of those institutions, it is not in our interest to make a loan to a small business person if their survival is at stake on shrinking balance sheets that compromise their capital on a mark-to-market basis every day. They simply will not do it. The Federal Reserve, I think, has realized that, and that is why they are stepping into the private sector as a bank.

Now, I can give you a way to do it. I think the last time I did this, two of the most liberal economists in the world, way on the left of the spectrum, liked my idea. I am not sure anybody else does, but, you know, we could create—this is a hypothetical, caricature example, because you are right on. If you vote these—money from TARP to clean up the balance sheets of the financial institutions with the trickle-down effect to the ordinary homeowner who is losing a job and a home at the same time is not going to fly. I am a taxpayer. I wear that hat. That is not going to fly. I would not vote for that. I would not release that money for that purpose.

If those moneys were used to do something about the housing market, to mitigate, to help compensate me for taking a haircut and writing down my loan, or if I am a lender doing the same thing, and make more balanced demands upon housing, so housing prices will stop falling, and then all that stuff on the balance sheets of those banks which are tied to this asset residential real estate, those complex securities for which we cannot find a market because there are thousands of them and we cannot find price discovery, then those values would stop declining, and the balance sheet would be helped. The TARP money is better used setting up an entity, a Government entity like we did in the 1930's to buy and sell houses in the private market, take a bunch of them off, take the supply down, provide tax incentives to homebuyers to buy a house, and to stop the decline in housing prices. And then the levered stuff built on that asset in an extraordinary, unbelievable boom that nobody on the regulatory side really watched and it came tumbling down, we would work our way out of it.

As a taxpayer, I do not support $350 billion—and I did not at the beginning. The plan that was presented to the Democratic leadership of Congress by Secretary of Treasury Paulson and Chairman Bernanke, there were no hearings on that plan. It was misguided from the start. It was not directed at the problem. The problem is housing. You will not get the results you want from that money.

You cannot unless you can in legislation tell the banks exactly what to do with the money. I do not think you can do that.

What is going to happen is our banking system as we know it is going to change. All the major financial institutions are going to shrink immensely. There will be new, smaller banks with clean balance sheets that will enter, and over time the person you are talking about, the good credit risk, will get money but from a different place.

Senator WYDEN. The Chairman has been gracious to give me all this time, and my sense is we ought to send you three off to the Chairman's conference room to come up with this kind of package, because you are giving us some sensible ideas. And I think your last point is really one to wrap up on. You are really leading us to a fresh start and a start that says the primary obligation now is to look at these kinds of loans that will help small business and the people with mortgages that need assistance. I think that is the way to go. I don't know if we are going to get to vote on it in time, but I thank all three of you. And if you put together a package under the Chairman's auspices, I am going to be very interested in it.

Chairman Conrad, thank you for all the time.

Chairman CONRAD. Yes, sir, Senator Wyden.

I would like to close this out by asking each of you, if you had the power to put together a plan to deal with both our short-term circumstance and our longer-term circumstance, what would the elements of that plan be? Obviously, I am asking here in a truncated way, but if you were giving advice to the President-elect, if this responsibility were turned over to you, what are the things that you would want to make first principles? What are the things that you would want to make certain were addressed?

I will start with you, Dr. Berner.

Mr. BERNER. Thanks, Mr. Chairman. As I indicated in my testimony, I would start with the cause of the problem that we are in right now, the short-term problem. I would focus on fixing the financial crisis, and I would use some of the tools that I indicated.

Second, there is no question in my mind that fixing the crisis is going to take time, even if we use additional moneys and additional programs to offer assistance to small businesses, to the other markets that I mentioned, the municipal market, for example, which is depriving States and localities of the ability to finance themselves, and that is going to cause more pain in our economy if we do not do something about that.

Third, you know, I fully endorse Doug's view that we need to look at ways to enhance and to augment our automatic stabilizers in order to cushion the blow from this problem, because I think we need to be realistic and say this is not going to be fixed overnight, despite our best efforts and intentions to fix it. So extended unemployment insurance benefits and, you know, other things that we can sunset fairly quickly once the pain is diminishing—those are all useful.

But most important, I think, from the perspective of this hearing, I think, is let us make a commitment to really work on—taking the opportunity in this crisis—our longer-term budget and economic challenges. If we miss that opportunity, it just seems to me the

clock is really ticking on the window that we have to do something about that. Let us use this crisis in order to really make a commitment in a sensible way, to be realistic, to come up with a game plan to address those long-term problems. Those are some of the elements.

Chairman CONRAD. Very good. Thank you very much for that.

Dr. Sinai.

Mr. SINAI. Well, that is, Mr. Chairman, a very, very deep question, and probably some of the things that I might suggest would be way too radical for the political system at this time, including new banks and new things.

One of the things with the economic recovery program which is going to be coming, you have to be very, very careful about the spending side of that. It is about 60 percent now—it looks like 60 percent spending and 40 percent taxes. I tend to prefer—though it takes longer for tax reductions to lift the economy, I tend to prefer tax reductions as a Keynesian-type stimulus rather than spending increases, for all the reasons we know. Once there they have a life of their own. There are issues about efficiency, and there is a real strong movement in Washington now on spending on the infrastructure side, and I am concerned about that. I would prefer the mix to be more tax cut oriented. The lags are longer, but we have to remember that tax cuts for individuals or for business—I would favor them for individuals, permanent ones—have a financial side to it, and our consumers are financially distressed as well as spending distressed, and a dollar of money that goes to a household—some of it is saved, some of it is spent. That which is saved goes to repairing balance sheets, which are impaired, and prevent consumers from spending. That would probably help speed that up.

The other issues about the long run, you know, there is a sequencing problem, and our society and economy and financial system went through a metamorphosis. What it is like 3 years from now I do not think any of us can figure today. It is not going to be the same. Citigroup is an example. It is shrinking down to meet the size of the market. Hopefully there is enough time for it to do that before its survivability ends or the Federal Government has to put $100 billion into Citigroup rather than what they have put in. It is a never-ending sinkhole, taxpayer money into major financial institutions, without putting some major strings attached to that.

So I would punt on your question and respectfully ask Matt or somebody to trigger me to spend a little time thinking about it, and I would be happy to write a short set of suggestions to you, because I have not really given that kind of framework question the kind of thought time that it deserves.

Chairman CONRAD. Well, let me just tell you, that is very much on our plate here. We are having discussions about these questions right now, and the incoming administration understands, at least they have told me they understand, once the economic recovery package is put in place and once economic recovery begins—and I think everybody understands that is months down the road, and it may be a pretty tepid recovery when it begins—that we then have to face up to these long-term imbalances, because the baby boomers have begun to retire already.

One place where I might have a variance with—Dr. Holtz-Eakin, you say it is just the spending side of the equation. That is one place I strongly disagree. Deficits and debt are a function of the imbalance between spending and revenue. I do not know how you cannot deal with both sides of the equation. And while I would be quick to acknowledge the biggest share of this has to be done on the spending side, there is no way, as you describe—there is where I would agree with you. Anybody who think you are going to tax your way out of this is in a total dream world. That is not going to happen. The political system will not support it, and the imbalance created just on the spending side of the equation is so strong, if you go to the out-years here, with the baby-boom generation coming on, that spending has to be a central component.

But I do not know how you deal with this without looking at both sides of the equation, spending and revenue. And we have a revenue system that is broken itself. I mean, we have this massive tax gap. We have these abusive tax havens offshore. The Permanent Subcommittee on Investigations says we are losing $100 billion a year on these offshore tax havens. We have these abusive tax shelters where companies in the United States are buying foreign sewer systems and depreciating them on their books for U.S. tax purposes, and leasing the sewer systems back to the European cities that built them in the first place. My God, we have a system that was designed largely 50 years ago that is almost irrelevant—almost irrelevant to the reality we confront today of a United States that is no longer completely dominant, and we have to worry about our competitive position. We are running a $700 billion trade deficit. You know, at some point here, we have really got to get serious, and the time has come.

Anyway, I will give Dr. Holtz-Eakin an opportunity.

Mr. HOLTZ-EAKIN. Let me start with the latter comments and basically say I think we are saying the same thing. We know the budget projections. We know the spending growth. There simply is no way to avoid coming to terms with that spending growth. My concern is that the thing that you can do quickly is raise taxes, and if you attempt to do that early in the reform process—you know, 2010, 2011—people somehow think the pressure is off, they have solved the problem. They are wrong, of course, and worse, ramping up this tax system is going to damage the economy. This is a bad tax system that needs reform. So you start jacking up marginal rates and all the really inefficient things that will come out of that, you will do more harm than good. And that is my concern about tax increases. I understand the budgetary arithmetic about both sides, but I think we ought to focus on the real problem and educate people on where it is.

In terms of your first question about the near term, I finally found someone who agrees with me, and I am never going to let Allen Sinai testify alone again, because I absolutely think—you know, you have two different problems: a financial crisis and a sort of industrial traditional recession. In dealing with the financial crisis, you have to fix the TARP. The TARP has done two things, and other efforts will reinforce this. Because the use of the TARP has shifted through time—it has been extended now to car companies—and because the rules for who qualifies and what you get are not

clear, there is not a private sector institution that has any incentive to clean up its balance sheet. It just wants to sit there and wait and hope they get rescued. That is a terrible set of incentives. And if you build new programs on top of it, they will wait for the next program, too.

The only way to clean up the private sector balance sheet is acknowledge your losses, become a clean entity, and you go raise capital and make loans.

So I think Allen is right about how the dynamics work on this, and I think fixing the TARP is an imperative for the financial market. I have roundly——

Chairman CONRAD. Can I——

Mr. HOLTZ-EAKIN. Let me finish here. I have been roundly criticized for the notion that the TARP should be devoted to buying up mortgages, and I am shocked to hear other people think this. I mean, this you can do fast. I have a mortgage for $200,000. My house is now worth $150,000. That mortgage is the problem. It is a problem for me as a homeowner. It is a problem for the bank that originated it. It is a problem for everybody who has a securitized piece of it.

Let that person go in, get a new loan for $150,000, whatever the market value will bear, chip in the rest, get rid of the other mortgage. What does that do? It puts cash on balance sheets. It keeps people in their houses. It addresses the housing problem itself. It is just as expensive as you can—I mean, that is the problem. It is very expensive. And you will help some people who do not deserve help. There will be people who get that help who knowingly took a mortgage they could not support. That is the tradeoff you have. But I think that is something you should do.

And on the fiscal stimulus—and then I will answer your question—keep it simple. You know I do not believe in spending a lot of new money. If you are going to start infrastructure programs, put them through authorization, appropriations, do due diligence. Do not jam them in a stimulus bill.

Help people who are out of work, get them some money, beef up the automatic stabilizers. And I think a big tax cut is important, so what is our biggest tax? Payroll tax. Everyone pays it. It is an enormous burden, particularly on lower-income individuals. Get rid of the payroll tax. Sure, that is going to trigger Social Security reform, but you have to do that anyway. So help people. And the payroll tax is the single most potent thing you could address. It would help the labor market. It would help people. I would have a big payroll tax cut.

Chairman CONRAD. OK. Very thoughtful. Let me ask you this, and if I could ask each one of you in turn. Tonight we are probably going to face a vote on extending—well, it will be a resolution of disapproval with respect to the second half of the TARP money. Would you vote to allow the second half of the TARP funding to be available to the next administration? You understand under the law, even though this administration has asked for it, they would not be able to spend any of it. It would only be available to the incoming administration.

I will start with you, Dr. Holtz-Eakin. How would you vote?

Mr. HOLTZ-EAKIN. I would disapprove of giving the funds, and I would force the new Secretary of the Treasury to appear before Congress and explain with precision how those funds will be used, rather than broad, ambiguous authorities that have been stretched through time, and, you know, basically an operating plan that involves hiring your friends off Wall Street. I do not think that is the way this should happen.

Chairman CONRAD. All right. Dr. Sinai?

Mr. SINAI. The question is if you vote so the TARP is given to the President-elect, that is just the existing legislation around the TARP and the potential way that it might be used, it is the status quo. Yes, I wouldn't support that. I wouldn't support that. I would go along with Doug and start the clock anew with the new administration really quickly coming to you and asking for those funds and finding out exactly what they plan to do with them. The kind of thing that didn't happen the first time Congress was shotgunned into supporting this program.

Chairman CONRAD. Dr. Berner?

Mr. BERNER. Mr. Chairman, I think, you know, we are looking at an administration that comes in 5 days from now, and it is certainly imperative that we get from the new administration a detailed blueprint of exactly what they plan to do with the money.

My recommendations, as I said, would be to use those funds, and perhaps others if they are needed, for foreclosure mitigation, because I think that goes a long way to helping homeowners. And it goes a long way to cleaning up troubled assets.

I also think that we are going to need, as I indicated, to clean up the balance sheets of institutions and to liquidate those that are insolvent. That is the only way we are going to get our financial system back on track.

As far as the vote is concerned, I think you should demand and should get accountability for those funds, and if that means postponing the vote, so be it.

Chairman CONRAD. All right. The great thing about the U.S. Senate is when the vote is called, there is no postponing it. There is no wishing that it had been done a little different way. You vote. And we are held accountable.

I thank each of these witnesses. You have been very helpful and very thoughtful with respect to your recommendations to this Committee, and what you have said here today will be shared with our colleagues. And we very much appreciate the effort and the energy and the thoughtfulness that you have put into your presentations here today. I hope this Committee can call on each of you again in the future for your assistance.

We appreciate it very much. Thank you. The Committee stands adjourned.

[Whereupon, at 11:46 a.m., the Committee was adjourned.]

ADDRESSING SHORT- AND LONG-TERM FISCAL CHALLENGES

WEDNESDAY, JANUARY 21, 2009

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

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

Present: Senators Conrad, Whitehouse, Gregg, and Sessions.

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

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to welcome everyone to the Senate Budget Committee. Today's hearing is entitled "Addressing Short- and Long-Term Fiscal Challenges." We have a distinguished panel of witnesses with us today, all of whom are former Directors of the Congressional Budget Office. They are:

Dr. Alice Rivlin, who in addition to being the founding Director of the CBO, was also Director of the Office of Management and Budget, and a Vice Chair of the Federal Reserve, and is now Director of the Brookings Institution Greater Washington Research Program. Welcome.

Dr. Bob Reischauer, President of the Urban Institute, and, again, a former head of the CBO. During my tenure here on the Budget Committee, we had the services of Dr. Reischauer, and he enjoys a great deal of credibility, as do all of the members of this panel.

And Dr. Rudy Penner, Senior Fellow at the Urban Institute.

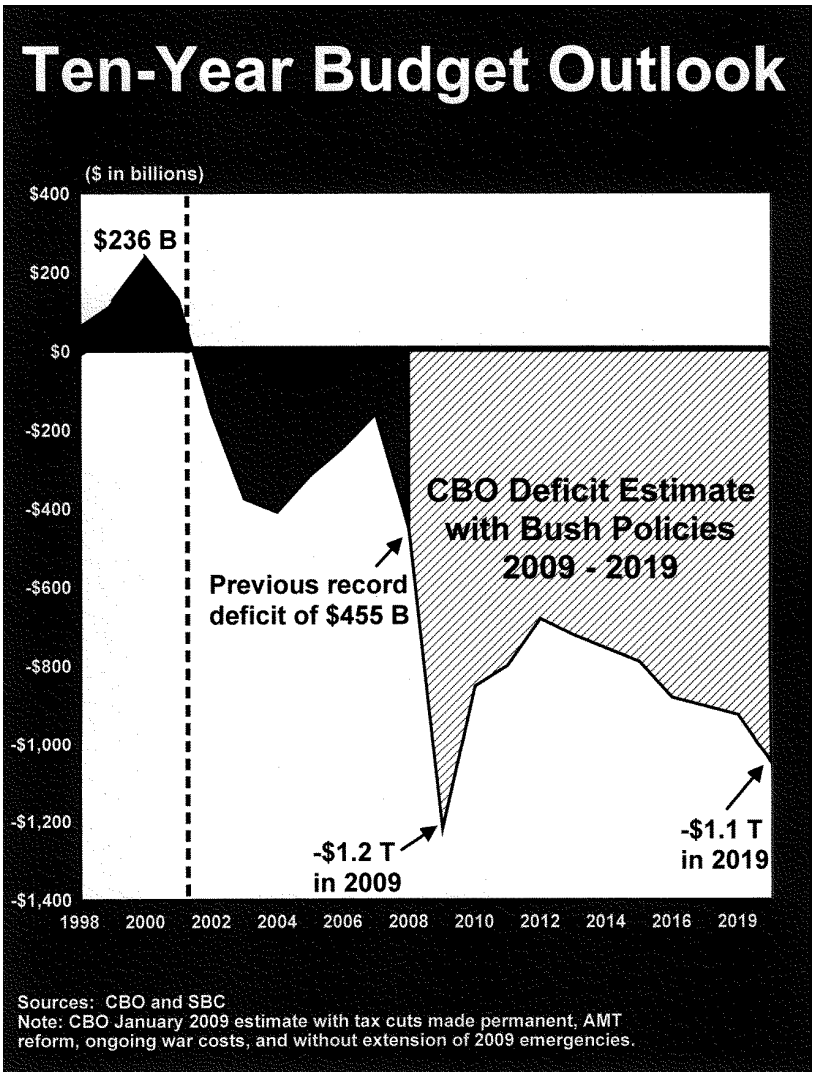
Thank you all for being here.

Our Nation faces really extraordinary short- and long-term fiscal and economic challenges. In the short term, we face the worst economic crisis since the Great Depression. Our first priority must be to get our economy moving again and to put people back to work. And it is clear that getting our economy moving again will require the passage of an economic recovery package that will further aggravate our deficit and debt.

But over the longer term, the combination of the retiring baby-boom generation, rising health care costs, and inadequate revenues are projected to explode Federal debt to an absolutely unsustainable level. So, in addition to addressing the current economic downturn, I believe it is essential that we begin the difficult work of putting our budget back on a sound long-term fiscal course. Our economic security will remain in jeopardy until we confront this problem.

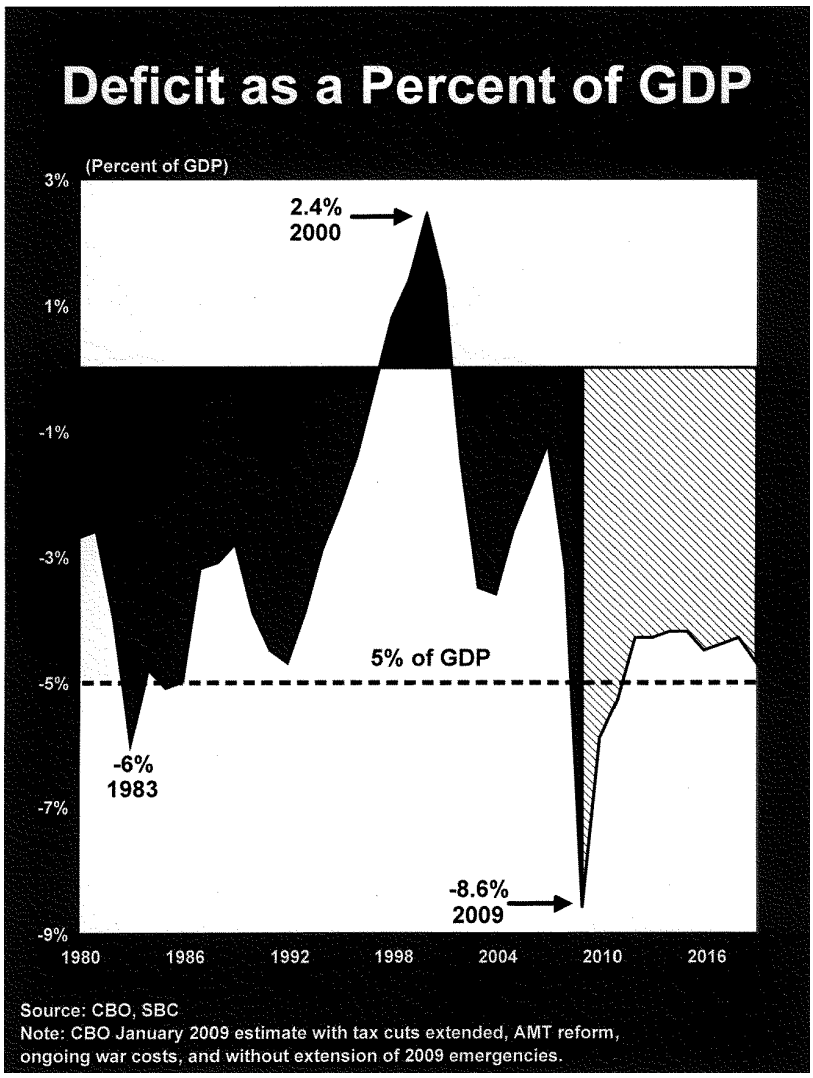
Let me begin by just briefly laying out what I see as the budget challenges that we face.

First, the news that we received from CBO earlier this month about the deficit was jaw-dropping. We face one of the worst budget forecasts I have ever seen. CBO's estimates show the deficit in 2009 will be $1.2 trillion, and I want to indicate that is before any economic recovery package. That is before any other new policy.



As a share of the economy, the deficit will reach 8.6 percent in 2009. That is well above the 6 percent of GDP that we saw in 1983, the previous post-World War II high. That eventually led to major deficit reduction efforts, and CBO's numbers show that under cur-

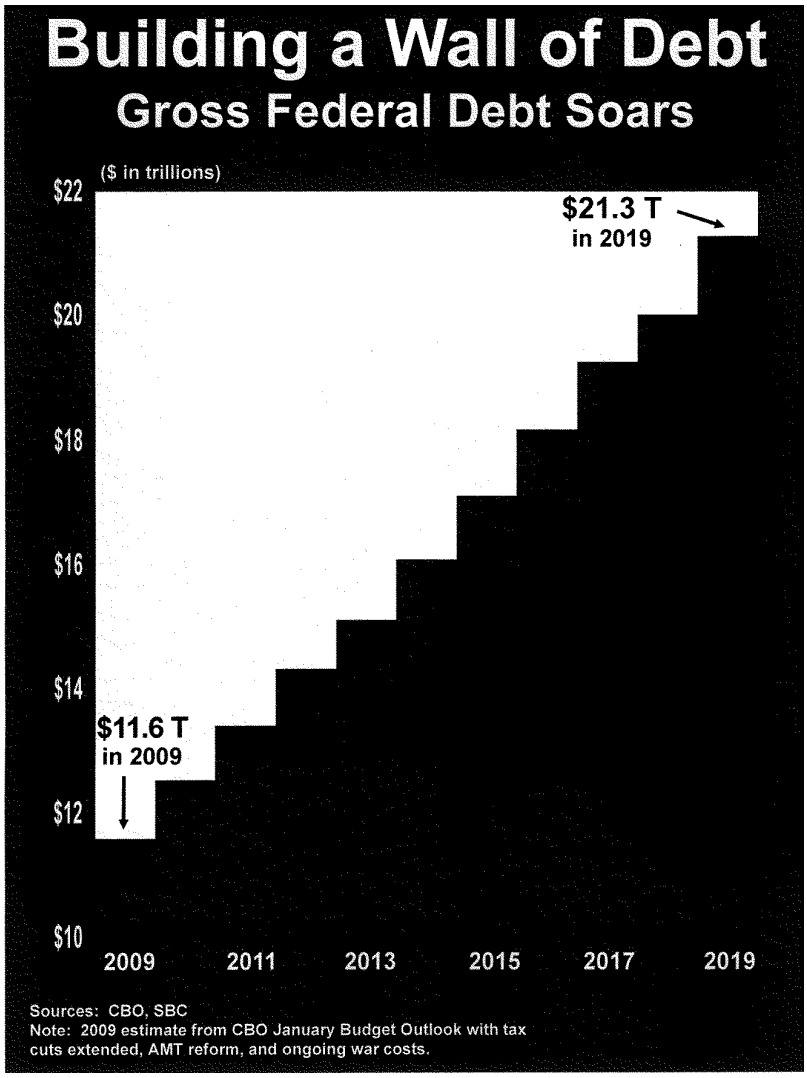
rent policies deficits will remain at 4 to 5 percent of GDP for the remainder of the next 10 years.

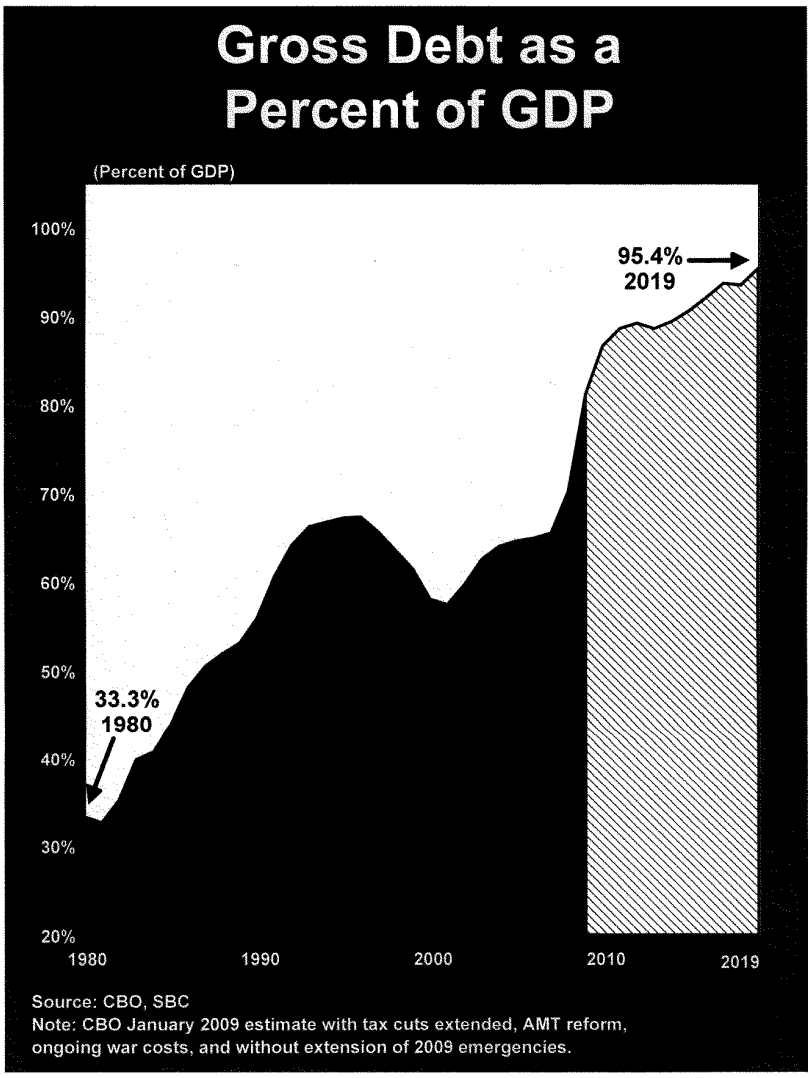


Let me just say parenthetically, my staff several weeks ago ran the 10-year numbers. They brought them to me, and I said, "These can't be right. Please run them again." They said, "Well, Kent, we have run these three times already. These are the numbers." And I tell you, anybody that looks at our long-term circumstance can't help but be sobered.

This absolutely requires a response. We are building a wall of debt. Gross Federal debt now is estimated to be $11.6 trillion at the end of this year. If we add in current policies, such as extending the tax cuts, AMT reform, and ongoing war costs, we could see

the debt rise to over $21 trillion by 2019. That approaches 100 percent of GDP.





And here are some of the major initiatives that are being considered that could further add to our debt: the economic recovery package, additional tax cuts, health care reform, additional defense spending. All of these are very much in place. So our long-term debt outlook is even more serious than the numbers reveal.

Major Initiatives That Could Further Add to Debt

- Economic recovery package
- Additional tax cuts
- Health care reform
- Additional defense spending

Here is a chart from CBO's long-term budget outlook, which was released in December of 2007. It shows what will happen to Federal debt over the next 50 years with the retirement of the baby-boom generation, rising health care costs, and the permanent extension of President Bush's tax cuts. Federal debt, if unchecked, would climb to 400 percent of GDP by 2058 if we stay on those trend lines. Clearly, that is unsustainable.

seeing what happens to home prices when the period of turmoil is over. Many analysts expect prices to rebound eventually, although probably few if any believe that the prices of houses and mortgage-related assets will return to levels that existed during the housing bubble.

Projections of house price declines are an important part of estimates of financial losses. CBO testified that "according to some analysts, U.S. banks and thrifts could be facing more than $450 billion in additional estimated losses on their assets—on top of the approximately $500 billion that has already been recognized."[3] Sensitivity estimates provide some insights to how losses respond to home price declines. For example, Goldman Sachs's mid-line estimate of $1.1 trillion of mortgage losses assumes another 10 percent price decline. Goldman Sachs estimates that if prices stabilize at current levels, then losses drop to $765 billion, but if prices fall another 25 percent, losses would jump to $1,842 billion.

Financial institutions have not recognized the full extent of their likely losses on mortgages and other securities, such as credit default swaps. Accounting standards give firms flexibility in valuing their holdings in many cases. GAAP is explicit in ruling out valuations based on fire sales. Moreover, firms do not have to mark their private-label mortgage-backed securities to market levels. Instead, firms can use cash-flow models to estimate values because each private-label security is unique. However, while house prices may in some cases fall below long-run equilibrium values. Many analysts believe that financial institutions have not gone far enough in marking down their assets on the balance sheet. The fact that many institutions trade below their book values provides some evidence supporting that claim.[4]

Questions from Senator Murray

(1) "Future Actions Needed to Strengthen Our Financial System"

a. Do you agree with the contention that many of our banks are insolvent and are essentially being sustained through government support?

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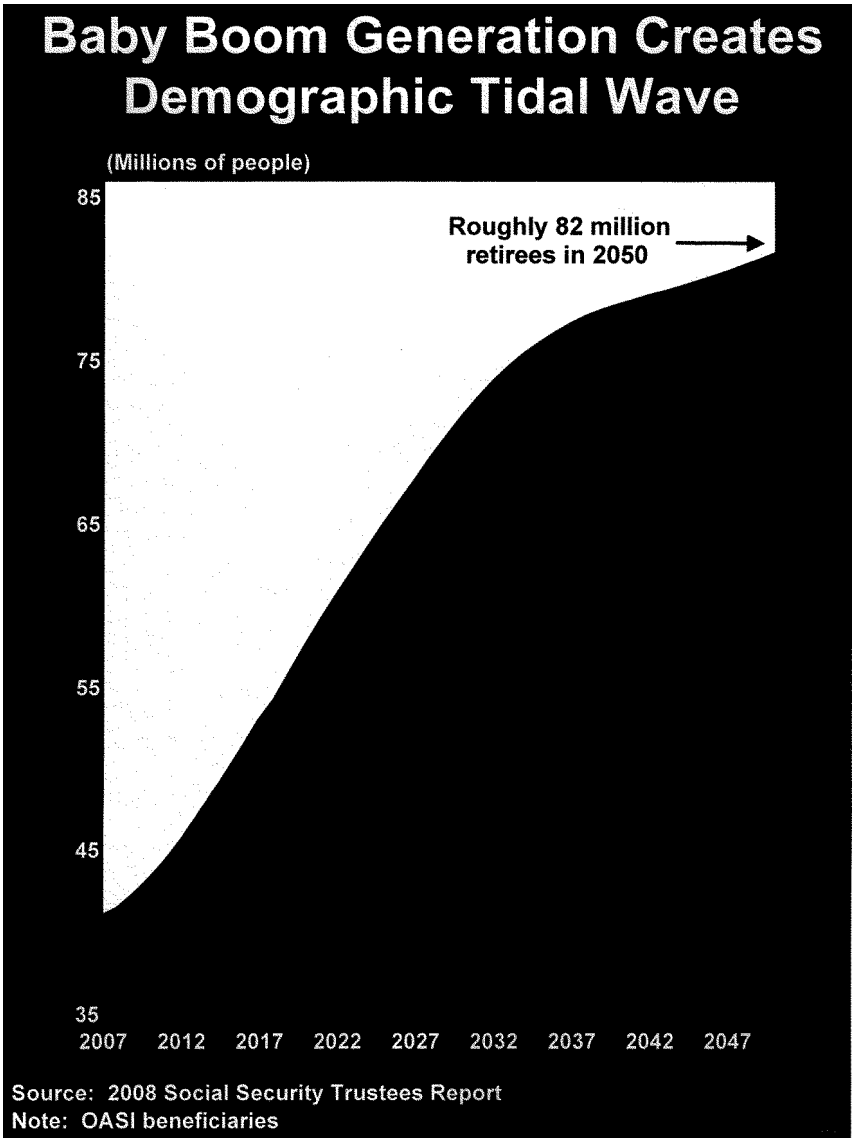
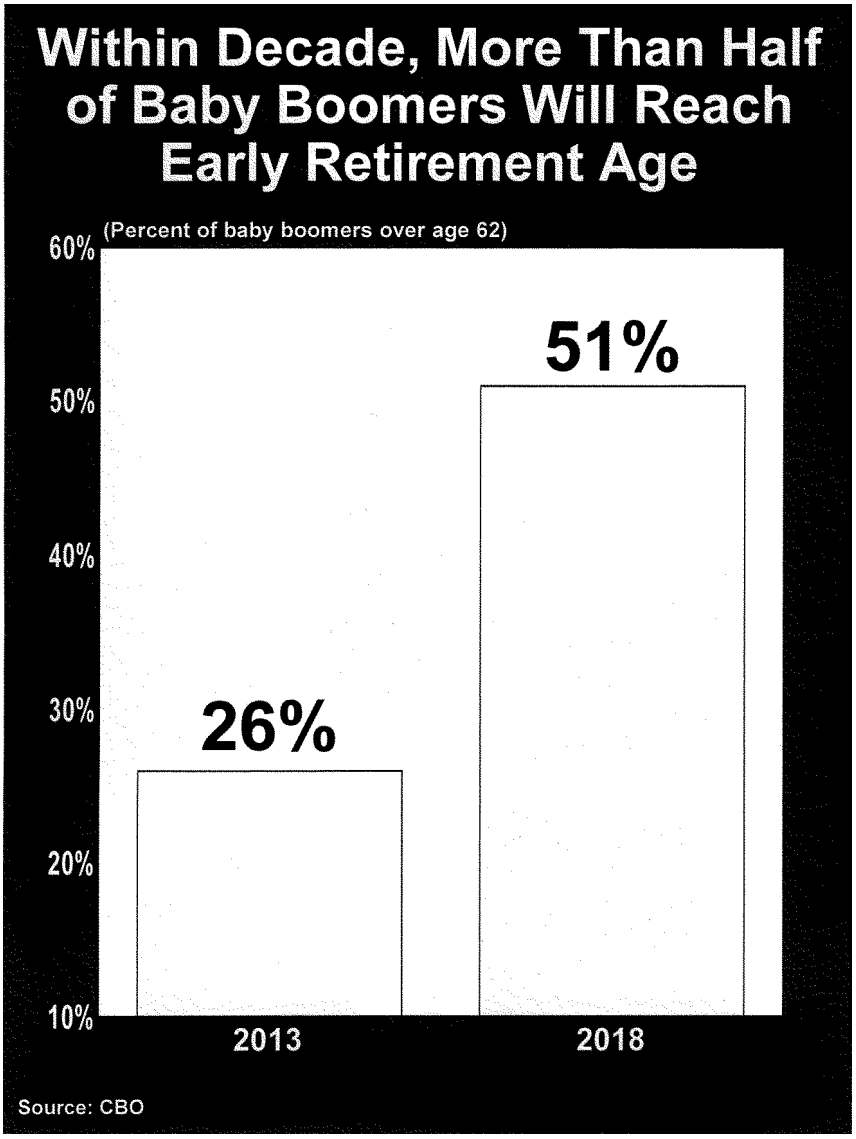
[3] For example, Goldman Sachs expects $2 1 trillion of losses on US credits with about half going to US banks. About $1.1 trillion of the losses are expected to be on residential mortgages Richard Ramsden, et. al , "As Mortgage Loss Estimates Continue to Rise, Further Policy Response Likely to Follow" (Goldman Sachs research, January 13, 2009). Also see, Jan Hatzius and Michael A. Marschoun, "Home Prices and Credit Losses: Projections and Policy Options," (Goldman Sachs, Global Economics Paper No. 177, January 13, 2009)

[4] As of November 2008, about half of banks were trading below their book value; frequently the discount was 20 percent or more See Statement of Robert H Herz, Chairman, Financial Accounting Standards Board, before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, March 12, 2009.

The explosion in debt we are seeing is coming at the worst possible time—right as the baby-boom generation is preparing to retire. We are facing, as this chart shows, a demographic tidal wave, and it is important to remember that within the decade, by 2018, more than half of the baby boomers will reach the early retirement age of 62.

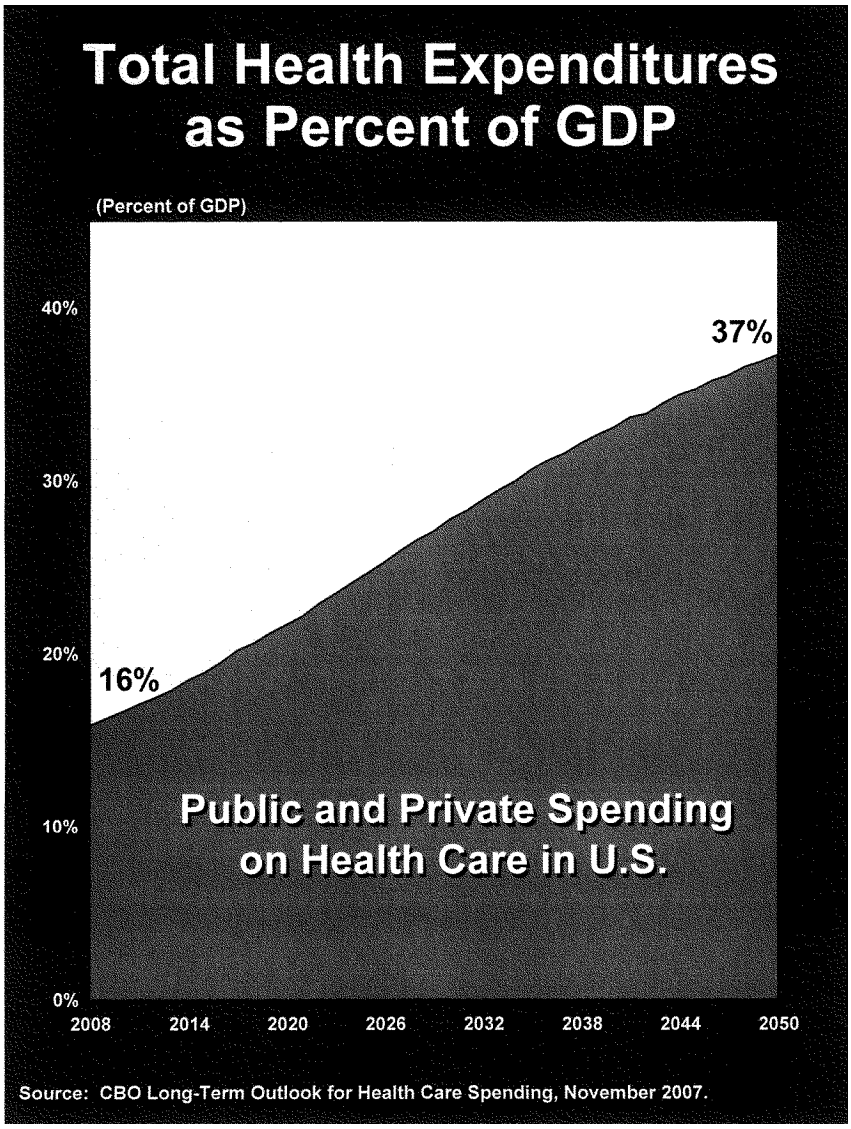

Baby Boom Generation Creates Demographic Tidal Wave
(Millions of people)
85
75
65
55
45
35
Roughly 82 million retirees in 2050
2007
2012
2017
2022
2027
2032
2037
2042
2047
Source: 2008 Social Security Trustees Report
Note: OASI beneficiaries



So some of my colleagues have said to me, "Well, yes, the baby boomers have started to retire, but it is going to be a long time before most of them are eligible for Social Security and Medicare." Oh, wish that that were true. No, no, no. Very quickly here, we are going to face the dramatically increased costs of the retirement of the baby-boom generation.

But this is far more than a demographic issue. Rising health care costs pose a tremendous threat. Rising health care costs are exploding the cost of Federal health programs, and private sector health

care spending has also exploded. Taken together, public and private health care spending will reach 37 percent of GDP by 2050.



Now, let me just conclude by saying Senator Gregg and I have come together in a collegial, bipartisan, bicameral way to propose a fiscal task force that would have these following elements:

It would be tasked with addressing our long-term fiscal imbalances. It would consist of a panel of lawmakers and administration representatives. Everything would be on the table. The panel's legislative proposal would get fast-track consideration, and Congress

would have to vote. It would be designed to ensure a bipartisan outcome.

Conrad-Gregg Bipartisan Fiscal Task Force

- To address long-term fiscal imbalance
- Panel of lawmakers and Administration officials
- Everything on table
- Fast-track consideration; Congress must vote
- Bipartisan outcome

Let me just stop there and say that if others have a better idea, we are all ears. One thing that is going to be unacceptable is to refuse to face up to this circumstance. I was delighted to see President-elect Obama indicate that he intends to hold a Fiscal Responsibility Summit in February. Representatives of the President-elect were in contact with me as recently as yesterday indicating that they want to work together with Senator Gregg and myself, and others who are interested, to structure this bipartisan summit on our fiscal future. And they see this as the beginning of a process to identify a plan to take on these long-term imbalances.

The President-elect has said so publicly and has committed clearly to a course of addressing these issues and taking them on. He told me in a phone call about 10 days ago that he knows this is not going to be fun and it is not going to be easy, but that it simply must be done. This can can no longer be kicked down the road.

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

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman. Thank you again for your introductory comments, which were right on point, as they have been for a long time relative to this problem; and your comments about what lies over the horizon—well, it is not over the horizon anymore. On the immediate horizon almost is the retirement of the baby-boom generation and the costs which are going to be put on the Federal Government which are not sustainable in their present structure. And then, of course, we have the immediate crisis, which is extraordinary, and nobody in our lifetime has seen

anything like this. Obviously, if you lived through the Great Depression you may have seen it, but nobody else has seen it.

And so it is great to have this very talented and exceptionally experienced panel here today to talk about how they quantify this problem and what they see as the best approaches to addressing it. My view is that the approach that we have laid out in our joint effort, which is to create a procedure to get to a resolution of these issues rather than putting policy on the table first and having it shot down by all the different interest groups, which always take sides around this town. We would rather set up a process to get to that policy, which requires decisions and then requires action that is the best approach.

As you said, it has to occur sooner rather than later, and I was extremely encouraged by the President's Inaugural Address yesterday and by his comments obviously prior to that. But he is clearly willing to take this on, and that is good news, because we need the Presidential leadership, and I certainly congratulate him and his team for raising this very high on their agenda with all the other issues they are confronting in the short run here relative to the economy and the international problems, especially in the Mideast.

So let us hope we can contribute to that with this hearing today, which I know we will be able to get some more information out there that will be useful in moving this process forward. I look forward to hearing from our witnesses.

Chairman CONRAD. Thank you, Senator Gregg.

We will welcome back to the Committee Dr. Rivlin. Thank you so much for taking your time to be with us and to give us the benefit of your insights. Please proceed.

STATEMENT OF HON. ALICE M. RIVLIN, PH.D., DIRECTOR, GREATER WASHINGTON RESEARCH, THE BROOKINGS INSTITUTION

Ms. RIVLIN. Thank you, Mr. Chairman. and Senator Gregg and members of the Committee. I am delighted to be here because I recognize the Committee leadership of this Committee in focusing attention on the long-as well as the short-run challenges of the budget. And I am glad you are keeping the fires burning here.

I strongly share the Committee's perception that the future viability of the United States economy depends on policymakers' ability to focus on two seemingly contradictory imperatives at the same time: The immediate need to take actions which will mitigate the impact of the recession and help the economy recover—actions that necessarily require big increases in the budget deficit; and the equally urgent need to take actions that will restore fiscal responsibility and reassure our creditors that we are getting our fiscal house in order—actions to bring the future deficits down.

I stress the word "actions" because I do not believe it will be sufficient to pay lip service to the long-run challenge while focusing only on the deficit-increasing responses to the current financial and economic crisis. Congress and the administration must work together on actual solutions to both problems at the same time.

I have in my prepared remarks some comments on the economy. They are gloomy, and I do not think I need to reiterate them except to say that I am one of those who think that the forecasts coming

out of the CBO and other worthy forecasters are likely to be too optimistic. The forecasts themselves may well get worse by the next time the Committee meets.

You do need an anti-recession package. It is clear that this recession is going to be very bad, and the Government should act quickly to mitigated the downslide with spending increases and revenue cuts that will stimulate consumer and investor spending, create jobs, and protect the most vulnerable from the ravages of recession. We used to call this "stimulus"—temporary spending or tax relief to jump-start the economy. It has now been merged into a broader concept of recovery package and investment in future growth. But I think an important distinction should be made between a short-run anti-recession package—what we used to call "stimulus"—and a more permanent shift of resources toward public investments in future growth. We need both.

The first priority is an anti-recession package that can be both enacted and spent quickly, will create and preserve jobs in the near term, and will not add significantly to long-run deficits. It should include temporary aid to States in the form of an increased Medicaid match and block grants for education and other purposes. Aiding States will prevent them from taking actions to balance their budgets—cutting spending and raising taxes—that will make the recession worse.

The package should also include temporary funding for State and local governments to enable them to move ahead quickly with genuinely shovel-ready infrastructure projects, including repairs, that will employ workers soon and improve public facilities.

Another important element of an anti-recession package should be substantial transfers to lower- and middle-income people, because they need the money in this situation and will spend it quickly. This objective would be served by increasing the Supplemental Nutrition Assistance Program, unemployment compensation, and the earned income tax credit. Helping people who lose their jobs to keep their health insurance and aiding distressed homeowners would also belong in this anti-recession package.

On the tax side, my favorite vehicle would be a payroll tax holiday, because payroll tax is paid by all workers and is far more significant than the income tax for people in the lower half of the income distribution. Moreover, it would be fairly easily reversible.

But the anti-recession package I believe should be distinguished from longer-run investments needed to enhance the future growth and productivity of the economy. We need those, too. If our economy is to grow sustainably in the future, we need to modernize our transportation system to make it more efficient and less reliant on fossil fuels. We need to assure access to modern communications across the country and invest in the information technology and data analysis needed to make medical care delivery more efficient and effective. We need a well-thought-out program of investment in work force skills, early childhood education, post-secondary education, science and technology.

Such a long-term investment program, however, should not be put together hastily and lumped in with the anti-recession package. The elements of the investment program must be carefully planned and will not create very many jobs right away. Since a

sustained program of public investment in productivity-enhancing skills and infrastructure will add to Federal spending for many years, it must be paid for and not simply added to already huge projected long-term deficits. That means either shifting spending from less productive uses or finding more revenue. Over time, Congress could reduce commitments to defense programs and weapons systems that reflect outmoded thinking about threats to U.S. security, reduce agricultural subsidies, and eliminate many small programs that have outlived their original priorities. Reform of the tax system—including making the Tax Code simpler and fairer and increasing reliance on consumer taxation—could produce more revenue with less drag on economic growth.

None of this would be easy, but the resources to pay for large permanent increases in Federal spending must be shifted from somewhere as the economy returns to full employment. Congress will only be able to accomplish this reallocation of resources if it reinstates some form of long-run—say 10-year—PAYGO and caps on discretionary spending. I understand the reasons for lumping this all together, but I do not think it is a good idea.

Now, I do not need to reiterate for this Committee the challenge of the long-run deficits. You have stated them very well yourself, Mr. Chairman. The question, I think, is whether to approach this from a procedural point of view or from actual actions. I actually think that you need to do both.

In this situation, if the Congress and the administration together could take some actual actions quickly to mitigate the long-run upward trend in the deficit, it would be dramatic and useful. This crisis may have made Social Security less of a political "third rail" and provided an opportunity to put the system on a sound fiscal basis for the foreseeable future. And I would advise you to do that as quickly as possible.

Vigorous efforts should also be made to make Medicare more cost-effective and slow the growth of Medicare spending, which contributes so much to projected deficits. While restraining health spending growth should be a major feature of comprehensive health reform, Medicare is an ideal place to start. Medicare is a large payer for health services and should play a leadership role in collecting information on the cost and effectiveness of alternative treatments and ways of delivering services, and designing reimbursement incentives to reward effectiveness and discourage waste.

Fixing Social Security and taking aggressive steps to control the growth of Medicare costs would be visible evidence that Congress and the new administration have the courage to rein in future deficits. But the Congress also needs to restore discipline to the budget process, not use recession or the financial meltdown as excuses for throwing fiscal responsibility to the winds just when we need it most.

As you have said, this is not a partisan matter. I am very encouraged, as you are, by the President's willingness to focus on the issue of the long-run budget deficits. I think the joint plan of the two of you for a fiscal task force is a good one. In my opinion, we need action on many fronts at once, including a strong anti-recession package, immediate steps to reduce the contributions to future deficits of Social Security and Medicare, and agreement on reforms

of the budget process that will force the Congress to confront long-run spending and revenue choices.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Rivlin follows:]

Testimony of Alice M. Rivlin

The Brookings Institution and Georgetown University

Senate Budget Committee

January 21, 2009

Mr. Chairman and members of the Committee: I am very pleased that you are holding this hearing on the short- and long-run fiscal challenges. I strongly share the Committee's perception that the future viability of the United States economy depends on policy-makers' ability to focus on two seemingly contradictory imperatives at the same time:

- The immediate need to take actions which will mitigate the impact of the recession and help the economy recover—actions that necessarily require big increases in the budget deficit
- The equally urgent need to take actions that will restore fiscal responsibility and reassure our creditors that we are getting our fiscal house in order—actions to bring future deficits down.

I stress two sets of actions because I do not believe it will be sufficient to pay lip service to the long run challenge, while acting only on deficit-increasing responses to the current financial and economic crisis. Congress and the Administration must work together on actual solutions to both problems at the same time.

I will say a few words about the economy and then turn to the question of how to deal with the immediate and longer-run challenges of fiscal policy.

The Economic Outlook

We meet at a time of extraordinary uncertainty about how deep the recession will be and how long it will last. Forecasters all admit that they have little confidence in their ability to predict how consumers, producers, and investors at home and abroad will react to the cataclysmic economic events that have occurred. But people in the forecasting business still have to produce forecasts, so they do the best they can.

The Congressional Budget Office (CBO) forecasts that the recession will "last well into 2009" and that the economy will begin to recover slowly in 2010. CBO expects unemployment to peak at about 9 percent. The CBO is a bit more pessimistic than the Blue Chip average of commercial forecasters, because the rules of CBO forecasting do not allow them to take account of likely congressional actions to stimulate the economy and enhance recovery.

Right now I think we should be skeptical of all forecasts and especially conscious of the risk that things may continue to go worse than expected. The current CBO forecast is much more pessimistic than the one released just last September, and the Blue Chip consensus has been going steadily south for many months. Additional revelations of weakness in the financial services sector could further impede credit flows and produce a continued slide in all forecasters' expectations.

Indeed, uncertainty about the health of the financial sector compromises all current forecasting efforts. The economic models used by forecasters are based on the experience of the post World War II period, especially the last several decades. Not since the 1930's, however, have we experienced a downturn caused by crisis in the financial sector. Despite aggressive efforts of the Treasury and the Federal Reserve to stabilize the financial sector, credit is not flowing normally, even to credit worthy borrowers. Continued instability in the financial sector and credit tightness could deepen the recession and delay recovery.

Also adding to the uncertainty is the fact that before the current crisis Americans were consuming and borrowing too much, while saving too little. We had become an over-mortgaged, over-leveraged society dependent on the inflow of foreign credit. If recovery from this recession is to be solid and sustainable, we must stop living beyond our means. We must transform ourselves into a society that consumes less, saves more and finances a larger fraction of its investment with domestic saving, rather than foreign borrowing. This transformation is necessary, but it will put recovery on a slower track.

Indeed, not since we were a developing country have we been so dependent on foreign creditors. We are lucky that, even though this world-wide financial crisis started in the United States, the response of world investors has been to flock to the safety of U.S. Treasuries, which makes it possible for our government to borrow short-term at astonishingly low rates. But we cannot count on these favorable borrowing conditions continuing forever. Especially if we fail to take serious steps to bring down future budget deficits, the United States Government could lose the confidence of its foreign creditors and be forced to pay a lot more for borrowed money. Rapid increases in interest rates and a plummeting dollar could deepen the recession and slow recovery.

An "Anti-Recession Package" and Investment in Future Growth

Despite the uncertainty of forecasts it is already clear that this recession is bad and that worse is yet to come. Recessions always increase budget deficits as revenues drop and recession-related spending increases. These automatic deficits help stabilize the economy. In addition, since an unusually severe downturn in the economy is threatening, the government should act quickly to mitigate the downslide with spending increases and revenue cuts that will stimulate consumer and investor spending, create jobs and protect the most vulnerable from the ravages of recession.

What we used to call "stimulus" (temporary spending or tax relief designed to jump-start the economy) has been merged into a broader concept of "recovery" and investment in future growth. However, I believe an important distinction should be made between a short-term "anti-recession package" (aka "stimulus") and a more permanent shift of resources into public investment in future growth. We need both. The first priority is an "anti-recession package" that can be both enacted and spent quickly, will create and preserve jobs in the near-term, and not add significantly to long run deficits. It should include temporary aid to states in the

form of an increased Medicaid match and block grants for education and other purposes. Aiding states will prevent them from taking actions to balance their budgets--cutting spending and raising taxes--that will make the recession worse. The package should also include temporary funding for state and local governments to enable them to move ahead quickly with genuinely "shovel ready" infrastructure projects (including repairs) that will employ workers soon and improve public facilities. Another important element of the anti-recession package should be substantial transfers to lower and middle income people, because they need the money and will spend it quickly. This objective would be served by increasing the Supplemental Nutrition Assistance Program (SNAP), unemployment compensation, and the Earned Income Tax Credit. Helping people who lose their jobs to keep their health insurance and aiding distressed homeowners also belong in this "anti-recession" package. On the tax side, my favorite vehicle would be a payroll tax holiday, because payroll tax is paid by all workers and is far more significant than the income tax for people in the lower half of the income distribution. Moreover, a payroll tax holiday would be relatively easy to reverse when tax relief was no longer appropriate. This anti-recession package should move forward quickly. Because its components would be temporary, there would be little reason for concern about its impact on the deficit three or four years down the road.

The anti recession package should be distinguished from longer-run investments needed to enhance the future growth and productivity of the economy. The distinction is not that these longer-run investments are less needed or less urgent. We have neglected our public infrastructure for far too long and invested too little in the skills of the future workforce. If our economy is to grow sustainably in the future we need to modernize our transportation system to make it more efficient and less reliant on fossil fuels. We need to assure access to modern communications across the country and invest in the information technology and data analysis needed to make medical care delivery more efficient and effective. We need a well thought-out program of investment in workforce skills, early

childhood education, post-secondary education, science and technology. Such a long-term investment program should not be put together hastily and lumped in with the anti-recession package. The elements of the investment program must be carefully planned and will not create many jobs right away.

Since a sustained program of public investment in productivity-enhancing skills and infrastructure will add to federal spending for many years, it must be paid for and not simply added to already huge projected long-term deficits. That means either shifting spending from less productive uses or finding more revenue. Overtime, Congress could reduce commitments to defense programs and weapons systems that reflect outmoded thinking about threats to U.S. security, reduce agricultural subsidies, and eliminate many small programs that have outlived their original priorities. Reform of the tax system--including making the income tax simpler and fairer or increasing reliance on consumer taxation—could produce more revenue with less drag on economic growth. None of these policies would be easy, but the resources to pay for large permanent increases in federal spending must be shifted from somewhere else as the economy returns to full employment. Congress will only be able to accomplish this reallocation of resources if it reinstates some form of long run (say, ten year) PAYGO and caps on discretionary spending.

I understand the reasons for lumping together the anti-recession and investment packages into one big bill that can pass quickly in this emergency. A large combined package will get attention and help restore confidence that the federal government is taking action—even if part the money spends out slowly. But there are two kinds of risks in combining the two objectives. One is that money will be wasted because the investment elements were not carefully crafted. The other is that it will be harder to return to fiscal discipline as the economy recovers if the longer run spending is not offset by reductions or new revenues.

Immediate Action to Bring Down Future Deficits

As this Committee knows well, projections of the federal budget show rapidly rising spending over the next several decades attributable to three major entitlement programs; namely, Medicare, Medicaid and Social Security. Under current rules, Social Security spending will rise rapidly over the next two decades, but level off after the Baby Boom generation passes through the system. The health care entitlements are expected to rise even faster. Moreover, they are expected to keep on rising because they are dominated by continued increases in the spending for health care in both the public and private sectors. If policies are not changed Medicare and Medicaid—and to a lesser extent Social Security—will drive federal spending up considerably faster than the rate at which the economy is likely to grow. Unless Americans consent to tax burdens that rise as fast as spending, a widening gap will open up. We will not be able to finance these continuously growing deficits.

Because rapidly rising debt threaten our credibility as sound fiscal managers, we do not have the luxury of waiting until the economy recovers before taking actions to bring down projected future deficits. Congress and the Administration should take actual steps this year to reduce those deficits in order to demonstrate clearly that we are capable of putting our fiscal house in order. This can be done without endangering economic recovery.

The crisis may have made Social Security less of a political "third rail" and provided an opportunity to put the system on a sound fiscal basis for the foreseeable future. Fixing Social Security is a relatively easy technical problem. It will take some combination of several much-discussed marginal changes: raising the retirement age gradually in the future (and then indexing it to longevity), raising the cap on the payroll tax, fixing the COLA, and modifying the indexing of initial benefits so they grow more slowly for more affluent people. In view of the collapse of market values, no one is likely to argue seriously for diverting existing revenues to private accounts, so the opportunity to craft a compromise is much greater than it was a few years ago.

Fixing Social Security would be a confidence building achievement for bi-partisan cooperation and would enhance our reputation for fiscal prudence.

Vigorous efforts should also be made to make Medicare more cost effective and slow the rate of growth of Medicare spending, which contributes so much to projected deficits. While restraining health spending growth should be a major feature of comprehensive health reform, Medicare is an ideal place to start the effort. Medicare is the largest payer for health services and should play a leadership role in collecting information on the cost and effectiveness of alternative treatments and ways of delivering services, and designing reimbursement incentives to reward effectiveness and discourage waste. Congress has a history of allowing pressure from providers and suppliers (for example, suppliers of durable medical equipment or pharmaceutical companies) to thwart efforts to contain Medicare costs. The government has also not been adequately attentive to punishing and preventing Medicare fraud. The United States will not stand a chance of restoring fiscal responsibility at the federal level unless Congress develops the political will to hold health providers accountable—whether in the context of existing federal programs or comprehensive health reform--for delivering more cost effective care. A good place to start is Medicare.

Process Reform

This Committee does not need to be convinced that deficits matter and that the deficits looming in the federal budget--exacerbated by the rapid increases in debt associated with recession and financial bailout—must be dealt with sooner rather than later. You know that procrastination will make the hard choices harder and make us increasingly dependent on our foreign creditors and exposed to their policy priorities. The question is: should you take actual steps now to reduce future deficits or design process reforms that will force you to confront viable options and make choices in the future? My answer is: do both.

Fixing Social Security and taking aggressive steps to control the growth of Medicare costs would be visible evidence that Congress and the new Administration have the courage to rein in future deficits. But the Congress also needs to restore discipline to the budget process—not use recession or the financial meltdown as excuses for throwing fiscal responsibility to the winds just when we are going to need it more than ever. A large temporary anti-recession package is the right fiscal policy in the face of severe recession and should not be subject to offsets—that would defeat the purpose. But more permanent investments in future growth—also good policy—should be paid for and not allowed to add to future deficits.

Moreover, entitlements, which dominate future spending, cannot remain on automatic pilot outside the budget process. Fiscal responsibility requires that all long-term spending commitments be subject to periodic review along with taxes and tax expenditures. There is no compelling logic for applying caps and intense annual scrutiny to discretionary spending, while leaving huge spending commitments, such as Medicare or the home mortgage deduction entirely outside the budget process and not subject to review on a regular basis. I am a member of a bipartisan group called the Fiscal Seminar (sponsored by The Brookings Institution and the Heritage Foundation) that addressed this problem in a paper entitled, Taking back our Fiscal Future, in 2008. We may not have come up with the right solution, but we certainly identified a serious problem that stands in the way of getting the federal budget on a sustainable long run track.

Not a Partisan Matter

The challenges that face this Committee—mitigating the recession, enhancing future growth, restoring sustainable fiscal responsibility—cannot be solved by one political party, but require non partisan analysis and bipartisan cooperation. In my opinion they require action on two fronts at once, including a strong antirecession package and immediate steps to reduce the contributions to future deficits of Social Security and

Medicare. They also require agreement on reforms of the budget process that will force the Congress to confront long-run spending and revenue choices.

Thank you, Mr. Chairman and members of the Committee.

Chairman CONRAD. Thank you, Dr. Rivlin. Thank you for your wisdom.

Dr. Reischauer, it is very good to have you back, and you have been too long absent. Thank you for being here.

STATEMENT OF ROBERT D. REISCHAUER, PH.D., PRESIDENT, URBAN INSTITUTE

Mr. REISCHAUER. Mr. Chairman, Senator Gregg, and members of the Committee, I appreciate the opportunity to return before this Committee, and I, too, want to applaud the leadership and efforts that you as individuals and the Committee as a whole have shown in the effort to focus attention on the significant issues that face our budget and to do this in a constructive and bipartisan manner.

I will submit my prepared statement for the record and summarize it for you today.

Chairman CONRAD. Maybe I can just interrupt you for a moment to indicate that General Walker, the former head of the General Accounting Office, has joined us—somebody that in his previous capacity as head of the General Accounting Office testified frequently before this Committee and who enjoys great credibility before this Committee. We just want to welcome him back to the Senate Budget Committee.

I apologize for interrupting, Bob.

Mr. REISCHAUER. It was a well-deserved interruption.

It is well understood that we face two serious problems, and, unfortunately, the remedies for them are diametrically opposed. First, we have the short-run or immediate problem associated with the economic recession. I am not a forecaster, but my gut tells me that Alice's judgments on the consensus forecasts are right. I think it is more likely that the recession we are in is going to be deeper, longer and more difficult to get out of than those forecasts show, than the other options, which things will be better.

I say this because the roots of this recession are really different from any other that we have experienced in the post-war period. The main difference is that we have a financial services sector that is in tatters, and it has to be repaired. And you have to go all the way back to the pre-Depression era before you find similar kinds of situations.

Second, the stimulus that we are providing or are likely to provide is the traditional medicine that we have applied to different kinds of recessions. It is likely to be less effective to this recession because its roots are different.

And, third, it is worth noting that this is really the first recession that we have had when world economies have been as integrated as they are today and capital markets are electronically connected throughout the world. This makes responses very much more rapid and much more global than they have been in the past. So I, as I said, am dubious that this is not going to be a worse recession.

To battle this recession, we are going to have to have tax cuts and spending increases of an unprecedented magnitude, and that is going to lead to higher deficits and a significant expansion of the debt held by the public.

The second problem we face, as you have noted and Alice has spoken about, is the long-run fiscal sustainability problem. This existed, of course, long before the current recession. In fact, if you look at the projections from 6 months ago, you see that under a continuation of current policy, we were headed toward having deficits as a percent of GDP that were larger than at any time in the post-war period when we weren't either in a war or in a recession.

And from my way of thinking, it was not necessary to look out 50 years or 75 years to get nervous about this situation. We had about 7 to 10 years to begin fixing the problem, and if we did not move forward in that window, the risks, I think, would be quite unacceptable. So to solve this problem, we obviously need spending restraint, health care reform, and a judicious increase in taxes.

What has happened with the current recession is that we have received a wake-up call. We have been reminded of the risks that one runs when you seek to live beyond your means and delay hard choices and reforms that we know are unavoidable. Unfortunately, the debt that will be added and the size of the deficits over the next few years have shortened the window of time that we have to deal with the long-run problem. We probably have consumed what is the equivalent of 5 to 10 years of policy procrastination, and so that window that I talked about before has been compressed significantly.

Fortunately, there is little debate over the primacy of dealing with the immediate economic problem first, and there is broad bipartisan acceptance of the need to adopt measures that will put us on a fiscally sustainable long-run path.

The real debate that is emerging is whether we should deal with these two problems sequentially or concurrently. Many people will argue that we should deal with the problems sequentially—address the short-run problem first and then, when it is well in hand, turn to the sustainability challenge.

One reason to follow this approach is that if the economy does not recover, it would be both undesirable and counterproductive to take the steps needed to bring spending and revenues into line over the longer run.

The second argument is that the measures needed to put the budget on a more sustainable long-run path could reduce the effectiveness of whatever short-run stimulative policies we enact. For example, a higher fraction of any tax cut might be saved in anticipation of tax hikes scheduled for the future, or businesses may be reluctant to expand their capacity knowing that a period of fiscal restraint lay ahead. What is needed, the argument would go, is a single clear message from public officials that their full attention and efforts are directed at economic recovery.

Third, there is a great deal of uncertainty not only about when the economy will be in the midst of a strong recovery and capable of sustaining some kind of restraint, but also what the new economy might look like. The housing, automobile, State and local government, and financial sectors might look quite different than they did in 2007, and that should affect our views of how fiscal restraint should be meted out.

Strong as these considerations are, I would urge you to take action to deal with the two problems concurrently. There are at least three good reasons for following this approach.

First and foremost, we need to instill confidence in prospective lenders that we understand that we must and are willing to put our long-run fiscal house in order. The credit market turbulence of the last 6 months should convince everyone of the importance of confidence, the suddenness with which it can be lost, and the difficulty in regaining it once lost.

In recent years, we have depended very heavily on the willingness of foreigners to buy treasury securities. In fact, if you look at the period from December 2000 to September 2008, fully 74 percent of the $2.5 trillion net increase in privately held treasury securities was purchased by foreign and international interests. Looking forward, we have to ask whether these interests will be both willing and able not just to repeat their recent participation but to double or triple their efforts, which is what will be required given the size of our projected deficits.

Some of the factors that explain foreigners' ability and willingness to invest huge sums in dollar-denominated assets have weakened in recent months. For example, oil is now closer to $40 a barrel than $140 a barrel, and some oil exporters will no longer have the large dollar surpluses to invest in our securities. The trade surpluses of the Asian exporting nations have diminished as the recession has slashed demand for their products. And their economies have weakened as well, so they are devoting more of their resources to stimulating their own economies.

Finally, a portion of the huge gains made from trading financial instruments, real estate, and equities sought, in the past, the security of treasury securities, and those profits, of course, are no more. Prospective purchasers of our debt instruments will be looking for some assurance that we will address, in a serious fashion, our long-run fiscal imbalance. They want to be assured that they will not experience excessive inflation in the United States or excessive exchange rate risk. It would be prudent to provide such assurance as we are asking them to dig deeper into their pockets to help us support the fiscal stimulus that we are about to engage in.

While Treasury borrowing rates have been at historic lows, we should not be fooled by this. This is largely the result of a flight to safety and liquidity, and it will disappear, I think, quite quickly when the economies around the world begin to bottom out and expand again. So I think we are running huge interest rate risk if we do not provide the confidence that we are going to deal with our long-range budget problems.

The second reason to take action now to put the long-run budget on a more sustainable path is that it may be politically more viable to enact future restraint at a time when significant amounts of more immediate pleasure are being allocated through the stimulus package.

The third reason for acting concurrently is that this appears to be one of those very rare moments in history when seeking sacrifice for the common good may be politically viable. We are a Nation that has elections every 2 years, and it turns out that there is never a good time to ask for sacrifice as a result. There is always a reason to delay.

We are going to see a situation, no matter how much we promise that the stimulus package is temporary, in which the beneficiaries of that package are going to get their appetites whetted for a continuation of this spending. They will, in many cases, be able to argue that whatever has been provided in the next year or two really has met only a fraction of the unmet needs that have developed over the last couple of decades. And they will say that the

positive impact of the stimulus will be negated if the spending is cutoff.

We have a new President, as several of you have mentioned, who is committed to addressing the long-run problem. The public seems to accept his call for responsibility, and there is a new mood of bipartisan cooperation on Capitol Hill. All these things together I think make this a propitious time to act.

By acting, I want to make it clear that I do not mean that we need to impose restraint immediately. That would clearly be foolhardy. What we need to do is make the decisions now, adopt measures that can slow the growth of spending or increase revenues over the long run. There is a wide range of measures that could provide additional assurance. At one end of the spectrum, of course, there are the promises, the solemn commitments, the pledges to submit budgets or pass budget resolutions that exhibit fiscal discipline. But if we look at history, we realize that these tend to be forgotten, evaded, or reinterpreted and, therefore, offer little in the way of credible assurance.

At a second level, there are budget process changes. I, like many others, endorse proposals to reinstate statutory discretionary spending caps in PAYGO, but you have to remember that these tools are designed to reinforce spending and tax restraint that has already been enacted. They are designed to keep the fiscal situation from getting worse, not make it better. Biennial budgets, joint budget resolutions and so on, I think, are more likely to offer opportunities for delay and conflict than to be vehicles to ensure that tough decisions are made.

Summits, bipartisan task forces, and base-closing commission-type entities can serve as effective mechanisms for defining politically viable packages of spending cuts and revenue enhancements when the will to act is present or the action is unavoidable. To be effective, however, they must be accompanied by strict timetables and ironclad procedural requirements that the Congress vote up or down on the package. And here I applaud the measure that the Chairman and Vice Chairman have introduced, which I think meets the test of an effective approach.

The highest degree of assurance that we can provide creditors, of course, would come from substantive legislation. Such legislation does not really require a large dose of sacrifice at any point in time. Small incremental changes made over a long period can be quite effective and be politically palatable. The poster child for this approach is the increase from 65 to 67 in the age of normal retirement, which was part of the 1983 legislation to strengthen Social Security. It first affected those turning 62 in the year 2000, and it will be fully phased in for those turning 62 in 2022. When this change began in 2000, there was hardly a peep. Nobody realized it was happening, and that offers, I think, a lesson for how one might go about dealing with some of the problems that we face.

If we wanted to send a clear signal that we are committed to putting the budget on a more fiscally sustainable path, Congress could enact measures that would apply a more accurate inflation index to both entitlement benefits and the parameters of the Tax Code starting several years from now. Additionally, you could index the normal age of retirement in Social Security and the age of Medi-

care eligibility to increases in adult life expectancy. Such measures alone would be far from sufficient to solve the long-run budget challenge, nor are they necessarily the most desirable way to bring our spending more in line with our resources. But they are simple, their impact is widespread, and they are very gradual in effect. Furthermore, I think they would send a clear and strong message to our creditors about our commitment to long-run fiscal responsibility.

While some may want to craft a larger and more appropriate package of measures, that task may prove to be very difficult given the demands that the current economic crisis will place on policymakers. Should such a package emerge after one adopted these simple measures that I have suggested, the Congress could easily reverse its decisions on those original things. Congress has an ability, I think, to drive backward that exceeds its ability to drive forward, and so undoing painful legislation is quite easy.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Reischauer follows:]

Addressing the Nation's Contradictory Fiscal Challenges

Statement of Robert D. Reischauer*

Committee on the Budget
United States Senate
January 21, 2009

Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss with you the challenges posed by the nation's fiscal situation.

It is well understood that we face two serious problems, the remedies for which are diametrically opposed. First, there is the immediate or short-run problem, which is the economic recession whose roots are to be found in the bursting of the housing bubble, the excesses of mortgage markets, and the implosion of the financial sector related to excessive risk taking. This recession, which is the first to occur since the world's economies have become highly interdependent and digitally connected, could well be the deepest, longest and most widespread since the Great Depression. To combat this serious downturn, we must stabilize housing markets, shore up the balance sheets of financial institutions as their regulatory oversight is strengthened, and stimulate aggregate demand. This will require tax cuts and spending increases of an unprecedented magnitude, which in turn will lead to higher deficits and a significant expansion of the debt held by the public.

Second, there is the long-run fiscal sustainability problem. Even before the current recession

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* President of the Urban Institute. The views expressed in this statement should not be attributed to the Urban Institute, its sponsors, staff, or trustees.

began, the nation was careening down a fiscally unsustainable path. Promises, primarily those related to entitlement programs in general and health-related entitlements in particular, were projected to push spending up far faster than current-policy revenues. Before the middle of the next decade, deficits relative to GDP were projected to begin rising to levels that we have not experienced in non-recessionary periods of peace. Over the course of the following decade, as the retirement of the baby boom generation got into full swing, the imbalance associated with a continuation of current policy would have raised the risk of economic instability to unacceptable levels. Spending restraint, health care reform and judicious increases in taxes represent the prescription for addressing the long-run fiscal imbalance.

The current economic crisis should serve as a wake up call, reminding us of the risks we run when we seek to live beyond our means and delay the hard choices and reforms that we all know are unavoidable. Unfortunately, the downturn has also shortened the window of time we have to address the long-term imbalance. The Congressional Budget Office has estimated that, even without further legislation, the deficit for the current fiscal year will be about $1.2 trillion or over 8 percent of GDP and the debt to GDP ratio will rise from 40.8 percent to 50.5 percent. With stimulus of the magnitude being discussed by the Administration and Congressional leaders and other high priority initiatives, the FY 2009 deficit could approach $2 trillion or about 14 percent of GDP and the debt to GDP ratio could top 55 percent. When he testified before this Committee, OMB Director Peter Orszag warned that deficits of about 5 percent of GDP could continue for the next five to ten years. Were this to occur, the debt to GDP ratio at the end of FY 2019 could exceed any we have experienced in over half a century. In short, the consequences of the current economic downturn are likely to be equivalent to about five to ten years of policy procrastination

in addressing our long-term problems.

There is little debate over the primacy of doing everything possible to forestall a further collapse of the economy and mitigate the hardship imposed by downturn on families, communities and businesses. Furthermore, there is broad bipartisan acceptance of the need to adopt measures that will put us on a fiscally sustainable path. The debate will be over how these two very different prescriptions should be joined.

Some will argue that we should deal with these problems sequentially—address the short-run problem first and then, when it is well in hand, turn to the sustainability challenge. One reason to follow this approach is that if the economy does not recover it would be both undesirable and counterproductive to take the steps needed to bring spending and revenues into line for the long run. A second argument is that measures needed to put the budget on a more sustainable long-run path could reduce the effectiveness of whatever short-run simulative policies we enact. For example, a higher fraction of any tax cut might be saved in anticipation of tax hikes scheduled in the future. Furthermore, businesses might be reluctant to expand capacity knowing that a period of fiscal restraint lies ahead. What is needed, the argument goes, is a single, clear message from public officials that their full attention and efforts are directed at economic recovery. Thirdly, there is great uncertainty about not only when the economy will be in the midst of a strong recovery but also what the new economy will look like. The housing, automobile, state and local government and financial sectors might look quite different than they did in 2007 and that should affect our views of how fiscal restraint should be meted out.

Strong as these considerations are, I would urge you to take actions to deal with the two problems concurrently. There are at least three good reasons for following this approach. First and foremost, we need to instill confidence in our prospective lenders that we understand that changes must be made in our long run fiscal policy. The credit market turbulence of the past six month should convince every one of the importance of confidence, the suddenness with which it can be lost, and the difficulty in regaining it once lost.

In recent years, we have depended heavily on the willingness of foreigners to buy Treasury securities. In fact, between December 2000 and September 2008, 74 percent of the $2.5 trillion net increase in privately held Treasury securities was purchased by foreign and international interests. Looking forward, we have to ask whether these interests will be both willing and able not just to repeat their recent participation but to double or triple their effort, which the size of our projected deficits suggests will be necessary.

Some of the factors that explain why foreigners have been willing to invest huge sums in dollar denominated assets in the recent past have weakened. For example, with oil closer to $40 a barrel than to $140 a barrel, some oil exporters no longer have large dollar surpluses to invest. The trade surpluses of the Asian exporting nations have diminished as the recession has slashed demand for their products. Furthermore, as their own economies have weakened, they have begun to use more of their available resources for domestic stimulus. Finally, a portion of the huge gains made from trading in financial instruments, real estate and equities sought the security of Treasuries; those profits are no more.

Prospective purchasers of our debt instruments will be looking for some assurance that we will address, in a serious fashion, our long-run fiscal imbalance and that they won't face either excessive inflation or exchange rate risks. It would be best to act to provide such assurance as we are asking for their increased participation so that we can avoid any risk premium on the interest rates we will pay. While Treasury borrowing rates have been at historic lows, this situation will not last. The flight of capital to safety and security, which explains these low rates, will reverse when economies around the world begin to bottom out and turn around.

A second reason to take action now to put the long run budget on a more sustainable path is that it may be more politically viable to enact future restraint at a time when significant amounts of more immediate pleasure is being allocated.

The third reason for acting concurrently to address the short and long run problems is that this appears to be a very rare and propitious moment to seek sacrifice for the common good. In a nation that has elections every two years, there is never a good time to impose restraint. There will always be a reason to delay. The stimulus package and other measures enacted to invigorate the economy are likely to whet the appetites of recipient interests. No matter how temporary we say the new spending or tax relief will be, affected interests will argue, often correctly, that it has met only a fraction of unmet need that has developed over the past decade. They will say that the positive impact of the stimulus will be negated if the spending level is not sustained. The new President's commitment to addressing the long run problem, the public's acceptance of his call to act responsibly and the mood of bipartisan cooperation that may be emerging on Capitol Hill combine to make this one of those very opportunities to tackle the difficult problem of fiscal

sustainability.

Concurrently enacting measures that address both of the nation's fiscal challenges does not mean that the restraint needed to put the budget on a more sustainable long-run path should be imposed in the near term. That would be foolhardy given the current state of the economy and the forecasts for the next year or two. Rather, what is called for is the adoption of measures that significantly raise the likelihood that fiscal restraint will occur when the current economic crisis abates.

There exists a wide range measures that vary in the assurance they provide that could constitutes serious effort: At one end of the spectrum are promises, solemn commitments and pledges to submit budgets or pass budget resolutions in the future that will exhibit fiscal discipline. Threats to veto fiscally irresponsible legislation and disembodied deficit targets, such as those promulgated under the Gramm-Rudman-Hollings legislation, fall into this food group as well. We have had many of such commitments in the recent past. They tend to be forgotten, evaded, or reinterpreted and, therefore, offer little credible assurance of change.

At a second level are changes in the budget process. I, like many others, endorse proposals to reinstate statutory discretionary spending caps and PAYGO but we must remember that these tools are designed to reinforce spending and tax restraint that has already been enacted. They are designed to keep the fiscal situation from getting worse not to make it better. Biennial budgets and joint budget resolutions are more likely to offer opportunities for delay and conflict than to be vehicles that ensure that tough decisions are made.

Summits, bipartisan task forces, and base closing commission type entities can serve as effective mechanisms for defining politically viable packages of spending cuts and revenue enhancements when the will to act is present or action is unavoidable. To be effective, however, they must be accompanied by strict timetables and iron clad procedural requirements that the Congress vote up or down on the package.

The high degree of assurance that creditors will be looking for that we will deal with our long-run fiscal problem probably can only be provided by substantive legislation that will reduce the growth of spending or raises revenues in the future. Such legislation need not require a large dose of sacrifice at any point in time. Small incremental changes made over long periods of time can have significant impacts on the budget's long-term sustainability and be politically palatable. The poster child for this approach is the increase from 65 to 67 in the age of normal retirement, which was part of the 1983 legislation to strengthen Social Security. It first affected those turning 62 in 2000, 17 years after its enactment, and there was hardily a peep from those who whose benefits were reduced. It will be fully phased-in for the 62 year old cohort in 2022.

If Congress wanted to send a clear signal that it was committed to putting the budget on a more fiscally sustainable path it could enact legislation that called for using a more accurate measure of inflation to index both entitlement benefits and the parameters of the tax code starting several years from now. Additionally, it could index the normal age of retirement in Social Security and the age of Medicare eligibility to increases in adult life expectancy.

Such measures alone would be far from sufficient to solve the long-run budget challenge. Nor are they necessarily the most desirable way to bring our spending more in line with our resources. But they are simple, widespread in impact, and very gradual in effect. Furthermore, they would send a strong message to our creditors about our commitment to long-run fiscal responsibility. While some may want to craft a larger and more appropriate package of measures, that task may prove to be very difficult given the demands that the current economic crisis will place on policymakers. Should such a package emerge from the 111th Congress, it would be easy to reverse the indexing legislation.

Chairman CONRAD. Thank you, Dr. Reischauer.
Dr. Penner, thank you so much for being here. Please proceed.

STATEMENT OF RUDOLPH G. PENNER, PH.D., SENIOR FELLOW, THE URBAN INSTITUTE

Mr. PENNER. Thank you, Mr. Chairman. Mr. Chairman, Senator Gregg, and others, thank you very much for the opportunity to testify, and I, too, congratulate this Committee for their efforts in the difficult pursuit of fiscal responsibility.

The prevalent theme in recent discussions of stimulus is that the risk that we shall do too little exceeds the risk that we shall do too much. But I think that we must ask how much of too much we can tolerate. The risks of overdoing it are severe and, in my view, are not emphasized enough in the current discussion.

I have several concerns regarding the proposed stimulus package: first, that the combination of highly expansionary monetary and fiscal policies may lead to an excessive boom.

If you believe the CBO forecast and the consensus on which it is based, most of the stimulus from this package will come after the trough in the recession. In other words, we must think of the stimulus package not as something that will ease the rise in unemployment but, rather, as something that will accelerate the recovery. If the Fed must put on the brakes, another recession would be possible.

On the other hand, if, as Alice and Bob suggested, the CBO forecast is wrong, I think we will know that fairly shortly. If the economic decline starts to accelerate in this quarter, then I think we are in severe trouble. For the CBO forecast to be right, the rate of decline either has to stabilize or ease very quickly. My favored solution would be to have a much smaller stimulus package but have other weapons in the wings to use if the decline exceeds the CBO expectations.

My second concern involves the speed with which the national debt is being increased. As Bob suggested, that could cause a very rapid rise in interest rates on treasuries, or in a worst-case scenario, create another bout of instability in international financial markets. The debt increase that we expect is extraordinary. Relative to GDP, the debt will increase in 2009 considerably more than twice the past post-war record, which occurred in 1983. The debt is going to increase at least 50 percent over the next 2 years. In other words, we are going to ask foreign and domestic investors, both private and government, to increase their holdings of debt by that amount. And the question is: How much of an interest rate increase will be required?

Now, even if bad things do not happen to interest rates, we know one thing with certainty, and that is that the interest bill on the debt is going to soar and become a budget problem in itself.

Like my two colleagues, I think it is very important to improve confidence for the long run, and that does mean tackling the long-run budget issues simultaneously with trying to stimulate the economy. And I think in the very short run, you hear a lot of discussion of the Congress actually increasing whatever package the administration puts forward. That would be a huge risk, in my judgment, and, if anything, the Congress should try to trim back the package.

My third concern is that the Federal, State, and local bureaucracies may not have the capacity to efficiently manage the huge in-

crease in spending that is being contemplated. Just to put it in perspective, the Federal budget for physical investment has been running about $120 billion a year. If you look at the House plan just issued, it is hard to classify some of that spending. But I think the increase for physical investment must be something of the order of $140 billion over 2 years or, in other words, about a 60-percent increase. That is just a gargantuan increase for the bureaucracies at various levels of Government to swallow.

My last worry is that a significant portion of the spending increases and tax cuts in the package will become permanent, despite the best efforts to prevent that from happening. What we are talking about here are huge increases in the budget, and if they are truly, truly temporary, they will have to be followed by huge cuts later. That is going to be enormously difficult.

So, again, to summarize my conclusions, it would be nice to have a smaller package with some tranches of further stimulus in the wings if necessary. But I think, again, just to repeat, the most important thing is that the Congress not increase the proposed package significantly.

While the budget problems that the Nation is going to face in the long run were clearly articulated by your opening statement, Mr. Chairman, the huge increase in the debt that we shall experience in the short run makes the task of reforming the budget much more difficult and more urgent. However, our short-run problems also present a golden opportunity. Short-run difficulties often make people more willing to accept longer-run reforms. Sweden, Canada, Germany, and Japan have all undertaken fundamental reforms in their social security systems in response to short-run crises.

Nevertheless, entitlement and tax reform are excruciatingly difficult politically. It will take a departure from normal procedures to make any progress. Therefore, Mr. Chairman, I think you and Senator Gregg are to be congratulated for suggesting a bipartisan commission that would make proposals that would then be considered as a package and voted up or down. I also think, as in your commission, it is appropriate that it consist of elected officials and a few high-level officials from the administration, because I think only elected officials can really solve this problem.

I believe that the only competing process that might have a chance of success is a bipartisan summit such as the one that fashioned an enormously important budget deal in 1990. And I think that maybe a summit has a few advantages over a commission that are more fully outlined in my full testimony.

Nevertheless, I think it may be worth giving the commission idea a trial run. Although soaring health costs present the most serious budget problem by far, it may well be advantageous to tackle Social Security reform first. Possible reform options are well known, and we know a good deal about their effects. If it proved possible to fashion a bipartisan reform of Social Security using a commission such as you suggest, the two parties might develop the trust necessary to take on the more difficult challenges of health and tax policy reform.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Penner follows:]

ADDRESSING SHORT- AND LONG-TERM FISCAL CHALLENGES

Rudolph G. Penner
The Urban Institute

Testimony before the Senate Budget Committee
January 21, 2009

I am not representing nor speaking on behalf of any organization. I am a salaried employee of the Urban Institute. The observations and suggestions I present should be identified as my own and not necessarily those of the Urban Institute, its officers, or its Board of Trustees.

ADDRESSING SHORT- AND LONG-TERM FISCAL CHALLENGES

Rudolph G. Penner
The Urban Institute[1]

Mr. Chairman, Senator Gregg and other members of the Committee, thank you for the opportunity to testify.

The Short Run

There is no doubt that these are perilous times. We economists generally rely on historical data to help understand the present and predict the future, but since World War II there has not been a historical precedent for what we are experiencing. There has not been the same sort of breakdown in credit markets and there has not been the same sort of astounding policy response. The Federal Reserve System has been increasing bank reserves at an explosive rate and we are considering a fiscal stimulus program many times the size of any ever contemplated.

Because we are in uncharted waters, it is necessary to be somewhat modest in providing policy advice. The prevalent theme in recent discussions is that the risk that we shall do too little exceeds the risk that we shall do too much. but I believe that there is a need for dissenters and we

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must ask how much of too much can we tolerate. The risks of overdoing it are severe and are not emphasized enough in the current discussion.

I have several concerns regarding the proposed stimulus package:

1. The combination of highly expansionary monetary and fiscal policies may lead to an excessive boom.
2. The speed with which the national debt is being increased could eventually cause a very rapid rise in interest rates on Treasuries, or in a worst case scenario create another bout of instability in international financial markets.
3. The federal, state and local bureaucracies may not have the capacity to efficiently manage the huge increase in spending that is being contemplated.
4. A significant portion of the spending increases and tax cuts in the package will become permanent and significantly worsen the very serious long-run budget outlook.

Risk of an Excessive Boom – One hears many dire economic forecasts these days, but considerable weight should be given to the recent forecast of the Congressional Budget Office. It tends to reflect the consensus forecast, but

it makes no allowance for the beneficial effects of a stimulus package. Nevertheless, the CBO expects the recovery to start later this year and be well underway in 2010.

The spending associated with the stimulus will play out over two years and because of time lags, the bulk of the expansionary impact will come after the trough implied by the CBO forecast. The infrastructure spending will be especially slow to get going. The description of the House plan refers to $64 billion of highway projects that can be started within 180 days and the bill would presumably finance $30 billion of that amount. It is worth emphasizing that 180 days is almost six months. Presumably, one can accelerate the timing somewhat, but then one must finance less worthy projects. Even tax cuts take about six months to have their full effect on spending according to recent estimates.

Consequently, if the CBO forecast is correct, it is best to think of the stimulus, not as something that will much limit the rise in unemployment, but rather as something that will hasten the recovery. If the huge monetary stimulus starts to have an impact at the same time, we could see a runaway boom that the Federal Reserve would have to stop in its tracks.

It is worth thinking back to the stock market crash of 1987. In response, the Fed poured liquidity into the system, although not remotely as

much as they have recently. Economic growth accelerated in 1988, inflation became a problem in 1989, and the Fed had to tighten to the point of causing the recession of 1990-91. Given that the policy response this time is very much more dramatic, the resulting cycle could be much more violent.

If, on the other hand, CBO is being too optimistic about the state of the economy, that should be evident in a very few months. Ideally, we would have a much smaller stimulus package today, but a supplement ready to go if things turn out worse than expected.

Increase in the National Debt – Recently, the CBO projected deficits of $1.2 trillion and $0.7 trillion in 2010. But these estimates do not include any stimulus program, any relief from the alternative minimum tax, extension of other temporary tax cuts, necessary war spending, or increases in other appropriations. It is reasonable to expect a deficit approximating $1.5 trillion in 2009 and something well over $1 trillion in 2010. The debt in the hands of the public is likely to rise from about 40 percent of GDP to 60 percent by the end of 2010. Relative to GDP the increase in the debt in 2009 alone will be two times the previous record set in 1983 when President Reagan was accused of running irresponsible deficits. The increase over two years will be about 50 percent. That is to say, we shall be asking private

and government investors around the world to increase their holdings of U. S. government securities by 50 percent in two years.

Currently, the appetite for U. S. debt seems virtually unlimited with the interest rate on 90 day Treasury bills almost zero. But the important question is, "What interest rate increase will be necessary to induce people to continue hold Treasuries once their desire for more risky securities returns to normal?" If the unusually high spread between corporate bond and Treasury interest rates starts to decline, the recovery will be slowed if the risk premium shrinks because Treasury rates rise instead of corporate rates falling. The situation will be even worse if a Treasury auction of debt fails, much as a German auction failed within recent days. We could see a recurrence of financial instability and that would be devastating to the economic recovery.

Whatever the probability of such unfortunate outcomes, there is one thing that we know with certainty. The interest bill on the debt will soar in future years and probably become a serious budget problem in its own right.

The Management Capacity of the Federal, State and Local Bureaucracy – The stimulus plan proposed in the House would enormously increase the budgets of certain agencies and for particular activities in the state and local

sector. To put the plan into perspective, total Federal spending on physical investment has been running at about $120 billion, the bulk of which is in the form of grants to state and local government. Highway spending has been less than $40 billion. It is not easy to be certain how much of the money in the House bill should be classified as physical investment, but it appears as though the annual budget would be increased by at least $140 billion over two years, i.e., almost a 60 percent increase. It looks like the Federal budget for highways would increase more than one-third. I do not hear of plans to increase the size of the federal bureaucracy temporarily by comparable amounts and one wonders whether the existing civil service can provide adequate oversight. Lesser percentage increases are implied for state and local investment budgets, but there are major areas in which the civil service could experience severe strains when asked to spend so much money in such a short time.

There are huge increases for scientific research of various types when it is hard to argue that scientists are among those hardest hit by unemployment. In fact, one wonders if there are enough extra scientists to do the work.

More generally, the budget increases are so large that there is bound to be much waste and some outright fraud. There is some risk that we shall

experience a Katrina rescue-type fiasco. I suspect that the money would be better spent if more were allocated to the safety net – unemployment insurance, food stamps and SSI.

Temporary versus Permanent Spending -- A relatively small proportion of the tax cuts and spending increases provide by the stimulus bill is intended to be permanent. It could be argued that none should be. However, the greater danger is that spending that is intended to be temporary will turn out to be permanent. Just as there will be huge increases in particular budgets at the state and local level, there will be have to be huge cuts once two years have passed. It is, of course, hoped that state and local revenues will grow enough in the recovery to supplant the temporary federal assistance, but that assistance is supposed to come to an abrupt end whereas the restoration of state and local revenues will occur gradually. There are bound to be severe mismatches and where the cessation of federal aid requires drastic cuts in budgets, it will take considerable political courage to end the so-called temporary program.

Conclusion – Although I feel that it would be much preferable to have a much smaller stimulus package with extra tranches waiting in the wings if

needed, that is probably a quixotic wish at this point. However, there is much talk of the Congress expanding whatever package the administration puts forward and I see that as being extremely risky. It would be far preferable and may enhance confidence in bond markets if the Congress were to trim the administration package to some degree. To the degree that the Congress alters the composition of the package, it would help to enhance tax cuts somewhat and reduce the reliance on infrastructure investments. Tax cuts may not get quite as much bang for the buck, but they will have an effect much more quickly. Infrastructure investments will be much slower to get going and to complete. A significant portion is also very likely to be wasteful. On the spending side increases in the generosity of safety net benefits are both likely to have considerable bang for the buck and to work quickly.

The Long Run

The budget problems that the nation will face in the long run are well known. Social Security, Medicare, and Medicaid constitute almost 50 percent of noninterest spending and all three programs are growing faster than tax revenues. The growth rate will accelerate as the baby boom retires. At the same time, our tax system is inequitable and terribly inefficient economically. It is hard to imagine using it to collect significantly more revenue without substantial reforms.

The huge increase in the debt that we shall experience in the short run makes the task of reforming the budget both more difficult and more urgent. However, our short-run problems also present a golden opportunity. Short-run difficulties often make people more willing to accept long-run reforms. Sweden, Canada, Germany, and Japan have all undertaken fundamental reforms in their Social Security systems in response to short-run crises.

Nevertheless, entitlement and tax reform are excruciatingly difficult politically. It will take a departure from normal procedures to make any progress. Therefore, Chairman and Senator Gregg are to be congratulated for suggesting a bipartisan commission that would make proposals that would then be considered as a package and voted up or down. I think that it

is appropriate that the commission should consist of elected officials and a few high level officials from the administration. Technicians have presented hundreds of policy options. Only elected officials and other high level policy makers can bargain their way to an acceptable compromise.

I believe that the only competing process that might have a chance of success is a bipartisan summit, such as the one that fashioned an enormously important budget deal in 1990. (The summit recently suggested by the president-elect seems to be quite different from the 1990 summit in that it would include a number of experts as full participants.) A summit can be thought of as an expansion of the Conrad-Gregg commission and the 1990 summit did provide a policy package for an up or down vote. Alas, they failed on their first try and had to go back and refashion the package before they could attract majority support.

I believe that a summit has a few advantages over a commission. It can have broader representation and its rules of procedure may not have to be as rigid. It can also do its work in private. The imposition of an up or down vote by a commission might be too much for the Congress to swallow and there may be less flexibility to try again if the first try fails. On the other hand, the openness and transparency of a commission may make their conclusions more acceptable to the public.

It may be useful to have a commission that tackles the budget problem sequentially. Although soaring health costs present the most serious budget problem by far, it may well be advantageous to tackle Social Security reform first. Possible reform options are well known and we know a good deal about their effects. The same cannot be said about the prominent options for reforming Medicare and Medicaid. If it proved possible to fashion a bipartisan reform of Social Security, the two parties might develop the trust necessary to take on the much more difficult challenges of health and tax policy reform.

Chairman CONRAD. Thank you, Dr. Penner. Thank you all.

I would like to wade right in. You know, this is what I would call a "target-rich environment." Everywhere you look we have got a challenge, and everywhere you look we have got an opportunity.

First of all, I want to thank all of you for your kind words about what Senator Gregg and I have proposed. I think it is absolutely imperative that we go down this path of addressing both the short term and the long term. I no longer believe putting off a plan for

the long term is viable. We have simply had too much ground lost as a result of this remarkable downturn.

At the same time, I am extremely concerned about our approach with respect to the short term. And let me indicate why I am concerned.

Between the second tranche of TARP or the second half of TARP and what has come over from the House, I do not personally see that we are maximizing the potential to deal with the short-term downturn. Why not? First of all, because I do not think we are dealing effectively with the housing crisis; second, because I do not think we are yet dealing effectively with the financial sector, and we simply cannot have a typical recovery without the financial sector being healthy.

I said the other day in an interview—and I noticed that Mr. Stephanopoulos used this to challenge Mr. Axelrod in his show—that I was somewhat skeptical about the notion that we would get the reduction in unemployment that many are forecasting as a result of this economic recovery program. And I said that because most of the modeling is based on a financial sector that is relatively healthy.

Our financial sector is not healthy, and so the typical modeling that shows the reductions in unemployment I think are just misplaced; and that we have got to go back and focus effectively on stopping the collapse in housing prices; and, second, to get the financial sector back in the credit markets and lending.

I would just ask each of you for your observations or reactions to those statements. Dr. Rivlin?

Ms. RIVLIN. I share your concerns, and I said in my prepared statement, I do not think we have models that will cope with this situation. Models have been calibrated on the experiences of the last several decades since World War II, and especially more recently, and as you pointed out, they just do not tell us what happens when the financial sector is not functioning.

So getting the financial sector functioning does seem to me to be a priority, and the question is how to do it. I did not think that the original idea of the TARP was very quickly workable. By the "original idea," I mean taking the toxic assets off the books. Nobody knew how to value them, so I think the direct injection was a better idea as a first pass. But it has not gotten the banks really lending again, so now I think that taking the toxic assets into something like a bad bank is probably a good next step. It is going to be expensive, and we do not know how quickly it will work.

I agree with you that we are not going to see much recovery until housing prices stop falling. But that is very hard to fix. We built too many houses. People were overleveraged, and I think housing prices, no matter what we do, are likely to fall further before they bottom out.

That leads me back to feeling that a truly temporary but quite aggressive stimulus is actually a good idea to mitigate the damage and get some money into the hands of people who will spend it. But I do think it will be temporary—should be temporary, and that we should not load into the same package a lot of long-run spending, which, however worthy, ought to be paid for.

Chairman CONRAD. I would just say in comment to your last statement, I have looked now at CBO's estimate of the economic recovery bill coming over from the House. Fully 62 percent of it does not spend out until after 2 years.

Ms. RIVLIN. Yes, and that is not stimulus. It is something else.

Chairman CONRAD. Yes. Whatever one calls it, it is not what Senator Gregg and I have tried to send as a message to our colleagues as appropriate, that it be temporary, that it be targeted, that it be timely. I mean, 62 percent of the outlays is after 2 years.

Mr. Reischauer, your observations on the larger question?

Mr.REISCHAUER. My observation is your diagnosis is absolutely right on the money. The problem here is we do not know what the appropriate prescription is. We know that what we have tried so far has not worked as well as we would want, and when we look at some of the alternatives, we are hesitant because we see problems of moral hazard, there are problems of rewarding the undeserving. We have a financial sector that is stressed, and the American people are understandably reluctant to pour huge amounts of their tax money into these organizations, the leaders of which have benefited disproportionately during the last decade by engaging in excessive risk taking. And they ask, you know, why should we save these folks, although the strength and health of our economy depends on the financial sector regaining its health.

So I think we have just a very difficult challenge ahead of us. I do not think there is a magic bullet out there. As I said, this is different from anything we have experienced in modern history. And it is going to probably lead to considerable dissatisfaction, both in Congress and in the public, about the steps we take.

Chairman CONRAD. Let me just say, I want to make sure that I do not leave a misimpression out there. When I talked about the CBO analysis of the House package, it is not the whole House package. It is the appropriated accounts. But, you know, that is over $350 billion of the $825 billion. But I do not want to leave a misimpression out there that I was talking about the whole House package. I am talking about the appropriated accounts. And I must say I find it very troubling. We are talking about 62 percent of that actually spending out not until 2011 and beyond.

Mr. REISCHAUER. I think some of this comes right down to what Alice has been warning about, which is that this is a package that includes both true stimulus and long-run investment. And it is that long-run investment that is going to play out over a longer period of time.

Chairman CONRAD. Dr. Penner, what would be your response? And then we will turn to Senator Gregg.

Mr. PENNER. Well, like my colleagues, I think you have diagnosed the problem accurately. It was the fall in housing prices that really brought down this financial house of cards that we had constructed over the years. And dealing with that, I think it is very difficult practically to deal with foreclosures themselves, because presumably you do not want to bail out the investors. Moreover, I am told that more than 10 percent of foreclosures, people just walk away and do not leave any forwarding address. And then you have a very large group of people that just cannot be helped. They are

so far over their head that if you try and help them, they will foreclose yet again.

So I do think that you have to focus on house prices. As a fiscal conservative, I never thought I would be making suggestions like this, but I do think we have——

Chairman CONRAD. Don't feel bad. We are all in the soup.

[Laughter.]

Mr. PENNER. Now we essentially own Fannie and Freddie, so they can be used to bring down mortgage rates. Some have suggested bringing them down as far as 4 percent to try and kick-start the housing market. I would even contemplate a tax credit for homebuyers, perhaps restricted to first-time homebuyers.

I, too, am just very dubious about trying to stimulate the economy with infrastructure expenditure. We have known since the 1940's how hard it is to get such investment going in a timely fashion. So whatever your judgment as to whether we need it or not, I agree with Alice. It should be considered as a separate package. And if we need it, we should be willing to pay for it.

Chairman CONRAD. Senator Gregg.

Senator GREGG. Thank you. Thank you, Mr. Chairman. I want to thank the panel. I find myself in agreement with so much that has been said. Let me try to just sort of summarize the problem as I see it, though. And I am not talking about the long-term problem. I am talking about the short-term problem.

Because this is such a unique downturn, unique recession in our history, I do not think classic Keynesian approaches are going to resolve the issue. I think we have to figure out where the Government can be most constructive in addressing the core problems, and I think the No. 1 place is in housing and the No. 2 place is in financial institution stability. And they tie together, obviously, very directly.

The question is: Shouldn't this stimulus package—in my opinion—be restructured along the lines of taking the vast majority of funds and putting them into an effort to restructure the housing situation to the extent that the Government can impact that by lessening foreclosures and by looking for owner occupants, and by forcing down the price of the face value of the mortgage in some sort of RTC structure or the FDIC proposals or something like that?

And, second, as we move down the road here, we are not going to get the economy going again until the American people have confidence that there is a better tomorrow financially for them. That is the bottom line. And they are not going to have confidence there is a better tomorrow for them financially until their home price stabilizes. And the banks are not going to be able to control the price of their assets and be able to maintain their capital until mortgage prices stabilize.

So I do think the Government has to step into this mortgage issue much more aggressively than we have, and the stimulus package is one of the ways I would do it, both with a tax credit and also with a very aggressive initiative, funded through either the FDIC or the Comptroller. It would be different than the RTC, but it would be the same concept.

Second, I think we have to clarify to the marketplace that we are not going to go to the English model here, because I think one of the reasons we are having problems with the marketplace is there is such uncertainty about where the Government is going to go with all this money that they are putting into these financial institutions. And nationalization, which is the English system, simply undermines the capacity to ever get private equity into the market to stabilize this. So I think we have to be very careful as we put all this money in that we use vehicles that publicly state we are not going to pursue nationalization as an option here.

And, third, my sense is we have got to monetarize a lot of this. We have got to set inflation targets and accept the fact that for a period here we are going to have to inflate and publicly state that that is our purpose, because this deflationary spiral that we may be headed into is more severe than an inflationary event of a short term, hopefully. We have got to figure out how we back out of it, and there ought to be a stated end game to how you back out of it.

Now, you folks may disagree with all that, but I would like to get your comments on those three approaches: focus on figuring out a way to stabilize the price of the real estate through addressing aggressively the mortgage foreclosure issue; second, address the issue of the financial system, making it clear that we are not going to nationalize and, therefore, we give the option for private dollars to follow us in and the markets stabilize enough so they are willing to; and, third, whether or not we need to monetarize the debt—get the inflation rate up.

Ms. RIVLIN. Shall I start on this daunting task of answering?

I basically agree with your feeling that we have got to stabilize housing prices and we have got to try lots of ways of doing it. I do not think there is any one magic answer, nor is it necessarily going to work right away. I think housing prices are probably going to fall further. And even if we——

Senator GREGG. Should we be focusing the stimulus, since it is all outside the 2-year window anyway, on housing as opposed to the other things that are making up the majority of the stimulus spending?

Ms. RIVLIN. I would focus quite heavily on housing, but I would not eliminate the things that we need to get some money out there quickly to people who are hit hardest by the recession and will spend it.

Senator GREGG. I like your idea of a holiday on the FICA tax. I think that makes a lot of sense. But we have seen historically from our last stimulus package that that is saved, it is not spent, because people do not have confidence.

Ms. RIVLIN. Well, the last stimulus package was partly saved, and it was a different kind of thing. But I think you can count on some spending—increases in the transfer programs will be spent quite quickly. If you raise food stamps, that goes to people who need it really badly, and they are going to spend it. And the parts of the stimulus package that gp tp vulnerable people—increasing unemployment, raising the EITC—I would do.

Let me come to nationalization. I agree. I do not think we have any tradition here of wanting the Government to run the banks.

What we have to do is make clear what the relationship of the Government to the financial institutions that it is bailing out is going to be in the future. And we have not made that clear. We cannot hand over a lot of taxpayer money to financial institutions without some rules about what they have to report and what they have to do. I think the public is going to demand that, and the new administration, I assume, is going to try to get that clearer. But we are not a country that would like to have the Government running the banks. I do not think anybody in the government wants to run banks at the moment.

[Laughter.]

Ms. RIVLIN. On reflation, we do not know how to do that. The Federal Reserve has been creating billions and billions and billions of reserves on the books of the banks, and we are getting money out there every way we know how. But you do not get reflation unless somebody wants to spend it. And at the moment that is not happening.

Chairman CONRAD. Dr. Reischauer.

Mr. REISCHAUER. It is certainly necessary to stabilize housing prices, but we want to stabilize them at a level that is sustainable, and we have to recognize that housing prices got way out of line with underlying incomes over the previous 5 or 6 years. In part, that was due to innovations in credit markets that allowed people to borrow huge amounts of money with very small monthly payments, temporary though some of them were. We do not want to create another artificial situation. We can use, explicitly use Federal resources to subsidize mortgage interest to some degree, but as I said, we do not want to re-create, in a slightly different form, the problem that we had before.

With respect to the threat of nationalizing the financial system, I agree with Alice; I do not think that is really anywhere on the card sheet right now. We are not a country that turns in that direction, although with respect to certain financial institutions, like Fannie and Freddie, an argument could be made that they should become nationalized entities. You know, I am not convinced it is the right set of arguments, but I think a case can be made.

On the last issue, I do not spend sleepless nights worrying that we are going to enter into a deflationary spiral and suffer the consequences that Japan did. A huge fraction of the reduction in price levels over the last 7 months has been because oil has fallen from $140 to $40 a barrel. It obviously cannot fall another $100. I do not think we have the underlying productivity rate of increase of Japan. And a lot more of what we do now is service sector types of activities.

And so while we might have some years of relatively low inflation, I do not expect to see years of zero inflation or slightly negative inflation.

Chairman CONRAD. Dr. Penner?

Mr. PENNER. Well, I agree that we have to do something about housing prices. I already talked about that before. I also think that there should be some tax cuts in the stimulus program. I have been a little concerned that much of the discussion involves changing withholding rates, which really dribbles out the tax cut over a long

period of time. I would act much more quickly with lump-sum injections into the economy.

We have to recognize that not much of that will be spent. Studies of the 2002 experience suggests that about 40 cents out of every dollar is spent the first quarter. There is much more disagreement about what happens in the second quarter. But 2002 involved an acceleration of a permanent cut, so just a temporary one would probably have less impact. Nevertheless, I think it is——

Chairman CONRAD. If I could stop you on that, this is something we are talking about right now. Do you have any sense what you get on a temporary cut?

Mr. PENNER. Well, I think immediately it would be less than 40 cents.

Chairman CONRAD. You know, there is some talk—there is a study that is going around that a lot of us have talked about that on the rebate program that was previously done, only 30 percent of that was spent in the first quarter.

Mr. PENNER. Yes, I think that is quite a reasonable estimate. There seems to be a consensus developing. But I also agree with Alice that I think you get more bang for the buck, if you expand the safety net—SSI, food stamps, unemployment insurance, the EITC—you will get more bang for the buck than the initial 40 cents.

With regard to the financial markets, in the early 1990's, the Swedes faced a situation almost identical to what we are facing today, and I think their experience really warrants a study. The one thing that they did which we did not do initially is that they made the rules very explicit right from the beginning. It was a very transparent kind of bailout. Now, I have enormous——

Chairman CONRAD. Can you tell us about—this is also something—you are really on kind of a hot-button subject, because a lot of discussion right now—Swedes in 1991–92, housing collapse, they put money, they put capital into the banks. Can you tell us what the conditions were that applied to the extent that you know them?

Mr. PENNER. I do not know them with great precision, but they performed what they call triage. They divided their banks into hopeless—the one extreme—which were essentially taken over by a government-type entity, I guess like the RTC; ones that were healthy and did not really need much help; and then a group in the middle where assistance would make the difference between life or death for the bank.

Now, how exactly they defined those three categories, I just do not have the information on that. But they did it very quickly and effectively, and in the end, they actually made a profit on the whole deal, as they were able to sell off——

Chairman CONRAD. Now, they took equity positions.

Mr. PENNER. Yes.

Chairman CONRAD. My understanding is they did not allow healthy institutions to use government funds to buy other healthy institutions. My further understanding is that they required—to the extent institutions received Government funds, they had to demonstrate conclusively that they expanded their extension of credit; and, third, that they restricted bonuses to executives in firms that required government assistance.

To your knowledge, were those conditions applied? This is what I have been told.

Mr. PENNER. I did not know about the last one, but it was my understanding that the first two were, in fact, applied.

Turning to the question of inflation and deflation, I guess I agree with Bob. I do not see a huge deflationary threat out there. We may well have falling price levels for a short period of time, but I do not worry a lot about it being built into the system as it was in Japan.

On the other hand, I think we do have to look at what the Fed is doing with some care. We are increasing bank reserves at Zimbabwe-type rates. I have not looked in the last couple of weeks, but the last time I looked, the annual rate of growth since September was over 500,000 percent.

So I think that is worrisome. Optimists say, well, they can vacuum them up very quickly. A wag said they will vacuum them up with a Hoover. But I am just not as confident, and it is just extraordinary the rate at which the whole Fed balance sheet has exploded.

Senator GREGG. I thank you for your thoughts and your input, and that is what I was looking for. These are ideas. There are so many ideas floating around here. We are trying to get some reading on them. But, again, I want to thank you for the strength of your statements today. I think they have been exceptional.

Ms. Rivlin, you and I—when I sat down at that end of the Committee, you used to testify regularly, and I sometimes disagreed with you. But today I found what you were saying to be right on, on so many things, as with all of you, that I just hope somebody else is listening to you. So good luck. Keep talking and keep those ideas out there.

Thank you.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Thank you very much, Chairman.

I would like to—I usually ask questions of witnesses, particularly witnesses as distinguished and knowledgeable as yourselves, but I would like to take this opportunity to make a point, because I think the discussion of sequencing of the economic recovery, addressing Social Security, for instance, and addressing health care is one that we could make a terrible mistake about if we did not understand the situation correctly, and for your sake, because you talk about this all the time, and to give me a chance to explain, I would just like to share how I see it, and if you disagree, you have certainly time to respond. So it is a question in that sense.

But I feel very strongly that, as has been said here, the health care problem is, I think, to use your words, by far the biggest problem that we face, and I see us having two very distinct toolboxes with which to address that problem.

One is the traditional bloody fiscal toolbox with its saws and clamps and those sorts of things. In less graphic terms, it is paying providers less when I think most providers feel they have been stretched pretty thin by Federal payments already, perhaps even intolerably thin, by putting an even bigger burden on our American industry to support the health care system when I think most folks believe that they are already sustaining an uncompetitive burden

in comparison with other States that have more efficient systems; by throwing people off health care coverage when we already have close on 50 million people without health care coverage; and by thinning out the benefits, even though the No. 1 reason for bankruptcy, at least until this recent crisis, in families has been that their coverage wasn't any good and their health care emergencies put them into bankruptcy. So those are very, very bad ways to solve the fiscal problem of health care. They enjoy really only one advantage, and that is that they can be applied immediately, so you can wait.

The other toolbox involves bringing our health information infrastructure into the 21st century, investing in it and overcoming the market failure that has prevented that technology from deploying itself. It is investing in quality improvements where those can be shown to reduce costs, which over and over again they can, and investing in prevention where it can be shown to reduce cost, which over and over again it can, and reforming the way the system is paid for so that it sends the right signals and we are not always trying to push custard up the hill when we are reforming the health care system but you get virtuous cycles running and it starts to improve itself.

That is a nice toolbox to be working out of, because it doesn't create those terrible harms to families, those terrible social costs, those terrible consequences. It actually makes health care better and more efficient and more transparent and, I would argue, considerably less expensive.

The problem is that that has a pretty significant administrative run-up before it can be really effective. We don't even have the governmental administrative architecture in place right now to deploy those ideas effectively. They are just ideas out there.

So I am really concerned that if we talk about this sequentially, first, we are going to deal with the economic problems, then we are going to look at Social Security, then we are going to look at health care, by the time we get around to looking at health care, we are too far down the road. I think we need to look at health care literally first if we are going to get into that first toolbox because the effects that we are looking for aren't going to be found right away, and I think anyway that beguiles people away from that notion leads us to an extremely dangerous precipice in the relatively near future when we have a fiscal imperative, what the Chairman and the Ranking Member frequently call a tsunami, coming at us on the one hand and really impossible political choices that that bloody toolbox produces, and we will have left ourselves no choice by not taking action now with the systemic reforms that, I think, beckon us to a much, much brighter and better day.

So I would love to have you respond to that.

Ms. RIVLIN. I agree with you the increase in health care costs is driving the long-run problem and is the most important thing to tackle, and also that this is the moment to get started on improving the delivery system and the quality. That is going to take upfront investment in health information technology. It better be smart investment. There is a lot of potential for waste here. But we need to gather the information to find out what treatments are effective, to change reimbursement so that it rewards effectiveness

and not waste, and that needs to be started now. I am encouraged, actually, that there is a lot of talk now, and more than talk, proposals, for doing the up-front investment. That is very important.

I do think there are some things in the old toolbox, though, that ought to be used and that the Congress has had very little courage in addressing Medicare particularly. There is no reason why durable medical equipment shouldn't be subject to competitive bid. Rejecting that, with all due respect, gentlemen, is ridiculous. The Congress has gone too easy on the pharmaceutical companies. Some changes there could bring down costs in the near future and be useful.

But I don't think that either you do this or you do that. You have got to do all of these things. We do need to tackle the deteriorating situation in the economy in the ways we have just been talking about. We need to get on top of the long-run budget problem. Simultaneity is necessary.

Senator WHITEHOUSE. Thank you.

Mr. REISCHAUER. I think you have analyzed the problem correctly. I would caution, though, that if we went on an all-out campaign to develop what I call the infrastructure needed for a reformed health system, that the savings that might result from that, from the reformed system, wouldn't begin to appear for probably 10 years, that this would be a cost increase, and an increase well worth making if you are sure you are going to get to the promised land.

One positive note is that the bill that was considered by the House does have very substantial amounts of money for comparative effectiveness, for IT, for various other elements of this and the administration under Peter Orszag's leadership, I think is very interested in pursuing this, as well. So I think we have a glimmer of hope that we might start out on the right path, but it is going to be a long time before, with the appropriate infrastructure, a reformed payment system can translate into a new and different kind of delivery system that will end up both improving health and costing less money than we otherwise would spend, not less money than we spend now probably.

Senator WHITEHOUSE. Mr. Chairman, I have gone over my time, but would you mind if Mr. Penner answered, as well, the same question?

Chairman CONRAD. No, I would—Senator Sessions, is that all right?

Senator SESSIONS. That is fine.

Senator WHITEHOUSE. I appreciate it. Thank you, Senator Sessions.

Chairman CONRAD. And, Senator Sessions, I will add to your time. Thank you for your accommodation.

Mr. PENNER. I will be very brief. When we argued for a sequential response, as in my full testimony and Alice and I didn't mean a long dragged out response. We talked about doing Social Security and the stimulus very quickly. But I would see getting to health care very quickly after that. But we do have to recognize that it is an extraordinarily complex problem, that unlike Social Security, we don't have good estimates of the effects of various options that might improve things.

I don't fancy myself as being a health expert, but those that I know talk about the need to do a whole lot of little things to improve incentives and I think there are a lot of things we can do, even just focusing on the Medicare program. So it is bound to be a much more drawn-out process than dealing with Social Security.

Chairman CONRAD. I thank the gentleman for his courtesy. Senator Sessions, we will add to your time commensurately.

Senator SESSIONS. Thank you, Mr. Chairman. I want to thank you for setting a tone of honest inquiry into one of the most difficult challenges we face. President Obama is committed to thinking through and trying to find some new ways to deal with these problems. That does not mean we deny reality, though, so we have got to deal with the reality and help bring sensible legislation to his desk. Out of the thousands of things he has to deal with, some realities are not going away.

I ran an ad in this last campaign. I got a lot of favorably feedback from it. It just simply said, there is no free lunch. Debts have to be repaid. Like Julie Andrews' line in "The Sound of Music," "Nothing comes from nothing. Nothing ever could."

Spending more money today to stimulate the economy comes from somewhere, and we are either going to raise taxes or do other things or inflate the currency.

Dr. Reischauer, the Chairman showed us a very troubling article, from the New York Times consistent with what you, indicated, I think, that said that the trade surplus for China, who has been buying so much of our debt, dropped from $50 billion a month last year to $20 billion a month. And assuming they increased some of their domestic spending, even if they wanted to buy from us, they are not going to have the money, and neither will the OPEC nations, as you indicated.

Does that not indicate that we are likely to have to pay higher interest rates to attract the kind of capital we need to fund this new spending? Dr. Reischauer, I will ask you, since I think you——

Mr. REISCHAUER. I think that is the case, and to the extent that Americans begin buying Treasury securities, that means they are going to save more and consume less, which is something in the long run we want to encourage, but in the short run, detracts from aggregate consumer demand and makes the recovery even slower.

Senator SESSIONS. Well, I worked with Senator Kennedy and we came close—Mr. Walker back there participated some—in creating a savings program just last year. At that time, saving in America was below zero. We were spending our savings rather than saving. Now, I think it is up to 4 percent or so as people have been faced with the realities. So that in one sense is good, but it does reduce sales at the store.

Isn't this—Dr. Reischauer, I will just stay with you—isn't this a natural readjustment, that we are just going to have to go through some of this and it is going to be painful and there is no way we in government can throw around enough money to stop this adjustment?

Mr. REISCHAUER. I think the answer to that is yes. It is why the three of us and many on this committee have been arguing for many years that when times are good is when we should be making these adjustments and these transitions. You can't live beyond

your means forever and when reality comes and smacks you in the face is usually the worst time to make these sorts of adjustments because the consequences are substantial.

Senator SESSIONS. Dr. Penner, you used these words. Housing brought down this financial house of cards, I believe was the phrase you used. I remember the letter Mr. Greenspan wrote to the Banking Committee in favor of Freddie and Fannie reform. In 2005, my colleague, Senator Shelby, fought hard to get that reform. It failed. He predicted financial disaster, really, in the financial markets. It was a very, very strong letter. I read a book recently written in 2006. It predicted the housing collapse. And the Wall Street Journal just had six economists or financial gurus who predicted the collapse in a front-page article.

So what was this house of cards that collapsed? Can you simply, for the American people, tell us what it was that got us to this point that we are in a very painful circumstance now?

Mr. PENNER. Well, sir, in the good old days of Jimmy Stewart, you had savers on one side and they put their money in a bank and the bank lent it out to possible home buyers and businesses and so forth. What happened over the years is that Jimmy Stewart's bank no longer kept the loans. They sold them. The securities that were based on these loans, particularly mortgage loans, got so complex, people didn't understand what was backing the security.

The securities, in turn, were purchased largely with borrowed money. Leverage exploded, and that meant that a very small decline in the ultimate price of a house would, as soon as a mortgage foreclosed or went delinquent, wipe out the whole equity of a highly leveraged purchaser. So it could destroy that particular lender. Even worse, we then created a whole business of insuring these securities against default in an unregulated way and the insurers turned out not to have anything behind their contracts, at least in the case of AIG.

So it was, in my view, a huge house of cards. I think I have heard Paul Volcker say that he doesn't think all of this financial engineering could have possibly been worth it in terms of the ultimate reduction in mortgage rates you got at the end of the chain. I am not sure of that, but certainly any reduction in those mortgage rates was very small relative to the kinds of risks that people took along this complicated chain that was created between the ultimate saver at one end and the ultimate investor at the other end of the chain.

Senator SESSIONS. Dr. Sunshine, our CBO Director, testified before this committee not too long ago. I thought he did a good job and was impressive. I think Dr. Rivlin and Dr. Reischauer said they thought this was going to be a deeper recession than he predicted. But taking his numbers and those of the top people in the Obama administration, they are projecting without a stimulus package, as I understand their numbers, the unemployment rate not reaching 10 percent. It reached almost 11 under the Reagan recessions, which laid the foundation for 20 years of economic growth, I think.

But I will ask your opinion. Don't we need to be careful that we don't throw a lot of good money for very little benefit if we have a realistic expectation that the economy will find its own footing

and come on back? You seem to be pretty optimistic since you are concerned about inflation.

Mr. PENNER. Well, I think it is a concern, which I enunciated. I think it is interesting to compare the response to the 1982 recession, when, as you say, unemployment went up to 10.8 percent, to this one. In 1982, there was essentially no monetary stimulus because Paul Volcker was still busily fighting inflation and double-digit rates on 90-day Treasuries persisted long beyond the trough of the recession. The only fiscal stimulus, which was kind of complicated, came from the Reagan tax cuts. They were very large, but I think it is fascinating that we took some of those back at the very trough of the recession with the TEFRA bill in 1982.

So we are responding very, very differently to something that so far looks to me very much like the 1982 recession, at least in terms of the percentage fall in unemployment, and that is why I suggested that there was a risk on the other side that we overdo it.

Senator SESSIONS. Would either of you like to comment on that? Dr. Rivlin?

Ms. RIVLIN. I think the question is, is this 1980–1982 or is it 1933, and it may be something in between. I mean, the problem with relying on the 1982 response was we did not at that time have a total meltdown in our banking system and we don't know whether that fact and the credit crunch will greatly worsen the chances of recovery. The Chairman said that earlier. I don't know. I don't think anybody knows. That is the problem.

Senator SESSIONS. Thank you, Mr. Chairman.

Chairman CONRAD. Could I just say that our analysis, and the reason I said what I said publicly, is because I believe the models that we are using now cannot capture the difference in the threat that we face. I just don't think these models that are based on the financial sector being relatively unfazed fit the current circumstance.

And so these models that say that instead of 11 percent unemployment, we will get 2 percentage points less with the economic recovery package, and by the way, I believe strongly in an economic recovery package. I have got issues with this one. But I believe we need it, but I don't believe we are going to get the same bang for the buck that you normally would given the damage that has been done to the financial sector. Our analysis shows, in fact, that we only get about half the bang for the buck that the traditional models show.

Now, we will see who is right and who is not right, but, you know, I have, and I am sure Senator Sessions, who is here, that you are hearing every day in your office from business people back in Alabama and people around the country you know. I have just had one of the leading businessmen in my State here for the inaugural. He has got major banking interests as well as real estate development interests. I will tell you, this credit crunch is real and it is having a ripple effect way beyond what we had seen in the 1982 downturn. That is what I believe.

Senator SESSIONS. I agree, and I talked to a businessman recently and was shocked to see how severe he got caught in a financial situation and how severe that could have been for him. But loans for automobiles are being advertised as zero percent. I talked

to a young couple recently. They are going to save about $300 by refinancing their mortgage at four-and-three-quarters percent or something like that. So there is some money out here.

I just don't know what the answer is. I agree. I am perfectly willing to admit that. And you and I joked before, but we have got this cycle in America, including President Bush, well, I believe in free market. I am inclined to say you either believe in it or you don't. Somebody said in the decline of a nation's values and old verities, they affirm the old verities verbally while they are doing exactly the opposite. So I am a little worried that some our principles, we have so panicked that we may be going too far.

Let me thank you again, because your hearings have gone to the core of the problem we face. I am quick to say I don't know the solution, but I have not seen any other hearings in the Congress, House or Senate, that I am aware of that are discussing the core problems we are facing and how we got into this mess and what it is going to take to get out of it. Thank you for your leadership.

Chairman CONRAD. Well, I thank you, Senator, and I thank the members of this committee who have been responsible. The one eternal verity I think you and I can agree on is debt has to be paid back. I come from a background, my grandfather owned bank stock in the Great Depression. My grandfather was a newspaper publisher. In those days, you had unlimited liability, so when there was a run on the bank, you weren't limited by the amount of your investment. That wasn't the limit of your liability. And so the banker, when there was a run on the bank, would call and my grandfather would have to take down another $5,000, another $10,000, didn't believe in going bankrupt. It took him 9 years to recover after the recession, to pay all of his bills and the interest due.

I think people in my State are acutely aware of debt, because we are an agricultural State, and debt can be a great help. Debt can be an incredible burden. And when you have too much debt, there are real consequences. You know, agriculture is very cyclical and so we have seen up close and personal, and I used to be the Tax Commissioner of my State, so I have seen it very personally, people coming in who had taken on too much debt and how it absolutely crushed them.

So this is not an academic exercise to me. I am very concerned about debt. I am concerned about national debt, corporate debt, individual debt. And while I recognize being able to get credit and buy a home when you have got 20 percent down, that is a wonderful thing, to be able to have a home for a family. I also know if you take on too much debt how it can crush people. I have seen it, and it is not pretty.

And I am extremely concerned about the trajectory of events here, and that is why we are having these hearings. We are going to continue to do it. We are going to keep a spotlight on these things and we are going to insist that our colleagues think about these issues.

I want to thank this panel very much for your taking the time and extending your energy and your effort to helping us better understand these issues. I can't imagine a more distinguished or credible panel than one that involves the three of you. So thank you

very much for your contribution to this committee and to the Congress and to our country.

Ms. RIVLIN. Thank you.

Mr. REISCHAUER. Thank you.

Mr. PENNER. Thank you.

Chairman CONRAD. The hearing stands adjourned.

[Whereupon, at 11:46 a.m., the committee was adjourned.]

FEDERAL RESPONSE TO THE HOUSING AND FINANCIAL CRISIS

WEDNESDAY, JANUARY 28, 2009

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

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

Present: Senators Conrad, Murray, Nelson, Sanders, Warner, Merkley, Gregg, Sessions, Bunning, and Alexander.

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

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to welcome our witness, the new Director of the Congressional Budget Office, Dr. Douglas Elmendorf. This is Dr. Elmendorf's first appearance before our Committee. Congratulations on your selection. I do not think we could have done better.

I was pleased to join the House Budget Committee Chairman John Spratt in recommending Dr. Elmendorf to be the CBO Director, and I am delighted that he has now taken his position at the helm of the agency. Given the extraordinary fiscal and economic challenges facing our Nation, it is more important than ever that we have someone of Dr. Elmendorf's stature leading CBO. I think it is fair to say that, on a bipartisan basis, those of us who were involved in the interviews—the House Republican Ranking Member, the Senate Republican Ranking Member's staff, the Chairmen of the two Committees—were delighted that we had somebody of Dr. Elmendorf's quality.

Our hearing today focuses——

Senator GREGG. And the Ranking Members.

Chairman CONRAD. And so were the Ranking Members, Senator Gregg says, and I really do think that represents the feeling of all of us after the intensive interview process.

Our hearing today focuses on the Federal response to the housing and financial crisis. Dr. Elmendorf has done extensive research and writing on both housing and financial market policy, so it is particularly appropriate that he is our witness.

Before I go further, I notice that Senator Merkley has joined us, a new member of the Committee. We want to welcome Senator Merkley. Senator Merkley previously served five terms in the Oregon Legislative Assembly representing House District 47 within the Portland city limits. He also served as the 67th Speaker of the Oregon House of Representatives. He has a B.A. in International

Relations from probably the most outstanding university in the United States, Stanford University—other than North Dakota State and UND—and has a Master's in Public Policy from the Woodrow Wilson School at Princeton. In addition to the Budget Committee, he will serve on Banking, EPW, and the HELP Committee. Welcome.

Senator GREGG. Mr. Chairman, I would also like to welcome Senator Merkley, and I would just note that if he wants to come over to our side, we will give him a chair that works.

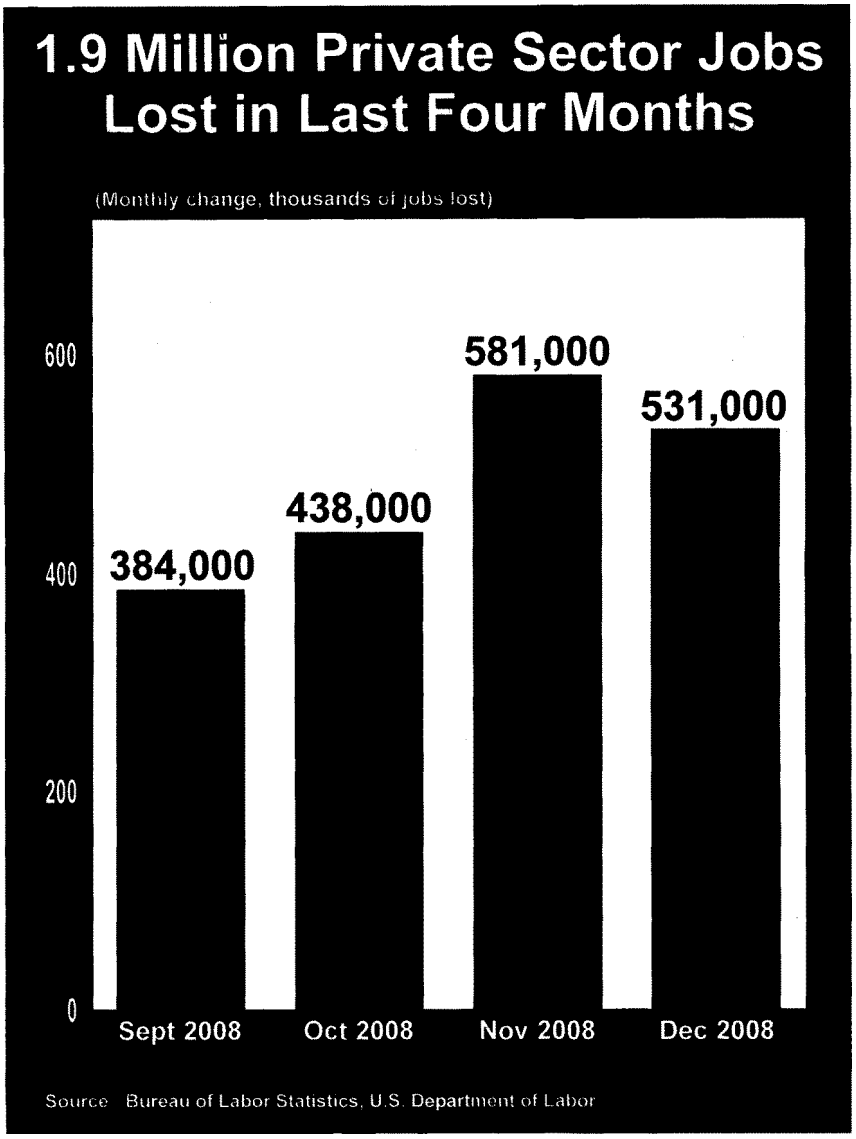
[Laughter.]

Senator MERKLEY. Mr. Chair, it is a delight to be here, and particularly to be here for a hearing on housing, which is so important to citizens in this country. Thank you.

Chairman CONRAD. We are delighted that you are here.

With that, I want to just proceed briefly and then turn to Senator Gregg for his opening statement.

I think we all understand that we are in the midst of the worst economic downturn our country has faced since the Great Depression. We have lost nearly 2 million private sector jobs in just the last 4 months, and we do not see that trend changing anytime soon.



In response, Congress and the administration are working on an economic recovery package. Here are highlights of the plan that is now under consideration.

It is designed to jump-start the economy, create jobs, lay a foundation for long-term economic growth. It includes investments in infrastructure, energy, health, and education. I would just say parenthetically that those are the investments I am most interested in and most supportive of.

It includes tax cuts for middle-class workers, families, and businesses. Last night, in the Finance Committee, we considered cer-

tain additional incentives for businesses that I hope will be incorporated in the mark before it comes to the floor. We received assurances from the Chairman of the Finance Committee that there will be improvements in that area before the mark comes to the floor, and also that the housing credit will be substantially strengthened.

Economic Recovery Package

- **Designed to jumpstart economy, create jobs, and lay foundation for long-term economic growth**
- **Investments in infrastructure, energy, health, education**
- **Tax cuts for middle-class workers, families, and businesses**
- **Increased food stamp and unemployment insurance benefits**

I offered an amendment last night to make the $7,500 housing credit apply to not just first-time purchases, but other purchases as well, although certainly not second homes or vacation homes, because I think it is going to need more impetus to help us get the housing sector back on track and clear the inventory that is out there.

It also includes increases in food stamps and unemployment insurance benefits, which have, I think we all understand, a strong stimulative effect because those moneys flow very quickly.

Unfortunately, I believe the economic recovery package as it is now structured does not adequately address the underlying housing and financial market crises that sparked the downturn in the first place. Senator Kerry and I had an op-ed that was recently published in the Wall Street Journal on this matter. I believe the economic models that predict lower unemployment as a result of the package assume generally healthy housing and financial sectors where credit flows. That clearly is not the situation we now face.

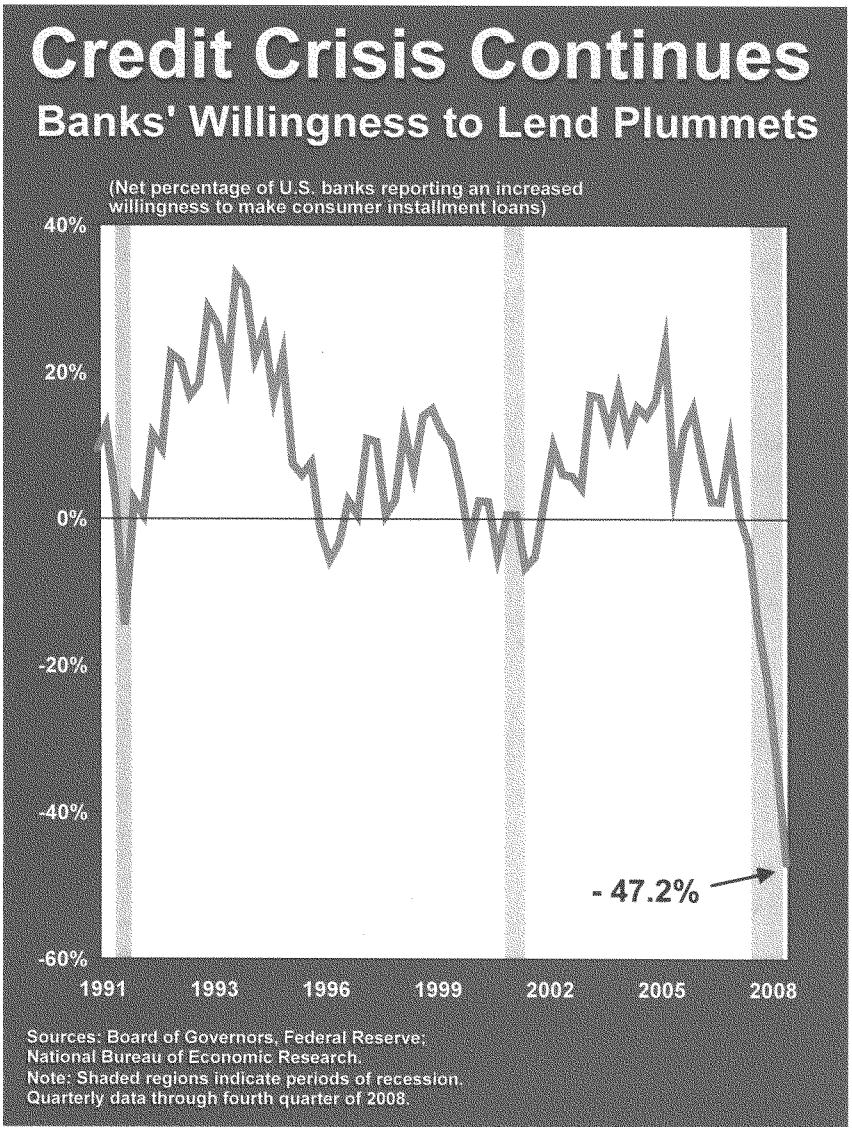
The housing crisis is continuing. One out of every five mortgages is underwater, meaning that the home is worth less than the remaining balance on the mortgage. Some say it is as much as one in every four. And one out of every ten mortgages is delinquent or is in foreclosure, and the credit crisis continues.

Housing Crisis Continues

- One out of five mortgages is "underwater" – with home worth less than remaining balance
- One out of ten mortgages is delinquent or in foreclosure

News over the weekend with respect to European financial institutions as well as our own should serve as a warning signal to us all. I noted in the Washington Post this morning a review of the major banks all around the world and their precipitous drop in value. That has significant warning signals attached to it, and we need to pay attention.

The chart I am showing now shows that about half of U.S. banks indicated they became less willing to make consumer installment loans in the final months of last year. Banks have not been that unwilling to lend in over two decades.



The weaknesses in the housing and financial sectors are creating a vicious cycle. Credit remains largely frozen, lack of credit causes layoffs, job losses trigger foreclosures, foreclosures hurt bank balance sheets further, and credit tightens even more. And the bad news on all these fronts hurts confidence, causing consumers to retrench further. So economists have told us we must address this underlying housing and financial market crisis for the stimulus package to be as effective as it might be.

In his testimony before this Committee earlier this month, Richard Berner, the Managing Director and Chief U.S. Economist for Morgan Stanley, said this: "As you debate a new fiscal stimulus

package, keep in mind that tax cuts and stepped-up infrastructure outlays, whatever their merits, do not get to the causes of this downturn. They mainly tackle its symptoms. In my view, two critical ingredients are still missing from the policy menu: first, cleaning up the lenders' balance sheets; and, second, mitigating mortgage foreclosures. Lenders will start lending again when they feel secure about their balance sheets. Likewise, mitigating foreclosures is necessary to stem the slide in home prices, slow credit losses, and reduce the pressure on household wealth."

The final point I would like to make is that as we consider how best to respond to our current economic downturn, we need to simultaneously prepare to pivot to address our long-term fiscal challenges. As I have said before, our Nation's long-term economic security will remain in jeopardy until we address the long-term fiscal imbalances that threaten to overwhelm the Federal budget in the years ahead.

Now, fortunately, President Obama is committed to tackling this long-term problem. In a Washington Post interview earlier this month, he announced he intends to hold a Fiscal Responsibility Summit in February to focus on this issue. He said then, "What we have done is kicked this can down the road. We are now at the end of the road, and we are not in a position to kick it any further. We have to signal seriousness in this by making certain some of the hard decisions are made under my watch, not someone else's."

With that, just before I turn to Senator Gregg, I want to indicate that Senator Warner has joined us as well. Senator Warner is also new to the Committee. I want to welcome him.

Senator Warner has been both a successful high-tech entrepreneur, having co-founded the cellular telephone company Nextel, and served as the 69th Governor of the Commonwealth of Virginia. During that time, he chaired the National Governors Association and was named by Time Magazine as one of America's five best Governors. He is also a former Senate staffer, familiar to many of us. Many of us consider him a friend, having worked for both Senators Abe Ribicoff and our colleague Chris Dodd. Senator Warner has a law degree from Harvard Law School—which we will not hold against him—and an undergrad degree from George Washington University. Welcome, Senator Warner.

Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Let me join you, Mr. Chairman, in welcoming Senator Warner. It is always nice to have former Governors on the Committee and in the Senate because they bring intuitive logic and thoughtfulness.

It is also nice to welcome Senator Alexander back. Sort of like Halley's Comet, he has returned to the Committee.

[Laughter.]

Senator GREGG. And we are honored.

I want to associate myself with the Chairman's remarks once again. I find myself doing that a lot recently. I think his definition and analysis of the problem is right on, that we need stimulus badly, but we need it in the right places. And the place where we need it is on the problem, and the problem is to get some value in

the real estate markets so that we can give people confidence again, because most people's primary asset is their home, and if they do not feel that their home has the value that they have invested or that they are paying a mortgage on, then they lose their confidence in their future. And, of course, the price of real estate and the ability to maintain real estate prices is critical to the financial industry which does the lending, and they have to be able to value their assets. So they need to be able to have a fixed value on their real estate portfolio, and in this economy that has been hard to get.

So, like the Chairman, I am disappointed that the stimulus initiatives that we are seeing so far—which, as the Chairman mentioned, were marked up in Finance and were marked up in Appropriations, where I am a member—did not address in a more aggressive and robust way the issue of real estate prices and how we keep people in their homes and how we reduce foreclosures.

Also, I am concerned that so much of the stimulus package is really outside the next 2 years. CBO has estimated, I believe, that over 50 percent will be spent out in 2011 and beyond on the appropriations side. And that is not good. I mean, we would like to get this money out the door sooner. The administration has said—and I respect Mr. Orszag's representation—that they are going to restructure this in a way that allows them to get 75 percent out the door in the next 18 months. I hope they can do that, but I tend to have more confidence in the CBO estimate, to be honest with you, because CBO is a fair arbiter on this issue.

So I believe that there are some adjustments which we can make in this stimulus package which would hopefully make it stronger and better. We do need a stimulus package. We need it badly. But we need it to be on point, and the point is that we have to get real estate prices and the real estate portfolios stabilized.

In addition, I want to express my appreciation for the outreach that the administration has done in this area. Yesterday, the President came to our conference, which is chaired by the Senator from Tennessee. He made an excellent presentation, I thought, and a substantive presentation, and addressed his approach and what they are planning to do in a very comprehensive way and in a way that gave me a lot of confidence that they are on the right track. But in that context, he talked about a three-legged stool, essentially, one of which is the stimulus; another of which is initiatives in the area specifically of stabilizing real estate prices, probably using the FDIC, although he was not that specific; and the third is the issue of cleaning up the balance sheets of the financial industries, again, probably through using a bad bank, although he was not that specific.

However, we have not seen the second two legs of the stool, and, thus, all we have to look at is the stimulus package, and the stimulus package as it is presently structured does not accomplish what I think needs to be done in that area. So we are going to be interested in your views on this. I think this is at the core of the present problems we confront.

I also want to second, of course, the ending of the Chairman's statement which reflected the need to address the long-term fiscal health of our Nation by addressing the entitlement issues, which

is critical, and now is a good time to do it. You know, we are in crisis. People are sober. There is a sense of community here that often does not exist in the Congress. There is a willingness to work across aisles. So let us move on that issue right now while the iron is hot and while we can get things done and while there is a good will to do that. And, again, I congratulate the President for stepping up and saying that he intends to do that, but I think sooner rather than later is the watch word on that.

So we look forward to your comments, Dr. Elmendorf. Thank you.

Chairman CONRAD. I thank the Senator for his comments.

Before we turn to Dr. Elmendorf, I would also like to welcome back to the Committee Senator Alexander, a very able and valued member of this Committee in a previous iteration. And we are absolutely delighted to have him back. This is such a critical time for this Committee and the Congress. We really need all hands on deck, and we need the best ideas of everyone. And we are very fortunate to have the best ideas of a new CBO Director here this morning.

Dr. Elmendorf, please proceed.

STATEMENT OF DOUGLAS W. ELMENDORF, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ELMENDORF. Thank you, Chairman Conrad, Senator Gregg, and members of the Committee. I am very pleased to be here for my first testimony before this Committee as Director of CBO and welcome the opportunity to talk with you about the turmoil facing our housing and financial markets and the options that policymakers have for addressing those problems. I want to make three points today.

First, turmoil in the housing and financial markets will continue for some time, even with additional policies, but especially without them.

Second, to generate a strong economic recovery, a wide majority of economists believe that both large-scale fiscal stimulus and focused financial and having policies are needed at this time.

Third, ensuring the availability of credit for qualified borrowers will require a multifaceted strategy that addresses the set of problems facing the financial system.

Let me elaborate on these points.

First, the trauma affecting our housing and financial markets has a long way left to run. Conditions in the financial system have improved in some important ways in recent months. For example, the interbank market for short-term loans, which had essentially seized up in the fall, is now operating more smoothly again. Risk spreads in the market for commercial paper have decreased. And interest rates on conforming 30-year mortgages have fallen a good deal.

However, these improvements do not reflect a return to normalcy by private markets and institutions but, rather, the aggressive policy actions taken by the Federal Reserve and Treasury. Moreover, despite these actions, for many borrowers credit is more expensive and more difficult to obtain than it was a few years ago.

As the Chairman's chart indicated, banks continue to tighten lending standards and terms for loans to both businesses and families. And the situation is likely to get worse before it gets better. According to some analysts, U.S. banks may experience another nearly $500 billion in losses on top of the $500 billion in losses they have already recognized.

Challenging conditions are likely to persist for some time in the housing and mortgage markets as well. Home sales remain weak, and construction activity continues to decline sharply. With a large glut of unsold properties, home prices will probably fall a good deal further, pushing the value of more borrowers' homes below the value of their mortgages. And as more of these underwater borrowers suffer income losses in the recession, rates of delinquency and foreclosure will rise significantly further.

A second point is that most economists think that further policy actions to restore the health of the financial system and the housing sector are needed. Broad-based fiscal stimulus will help the financial system to some extent by boosting incomes, and thereby reducing loan defaults. However, this indirect effect will not be sufficient to eliminate future losses by banks, much less to rebuild the financial system from the losses already suffered. So policies focused directly at the housing and financial problems are a crucial complement to stimulus, as Chairman Conrad and Senator Gregg have pointed out. Without such action, the economic recovery will almost certainly be more halting, and there would remain a larger risk of further economic decline.

Third, an effective policy to ensure the availability of credit to all qualified borrowers will require a range of tools addressing the whole collection of problems that we face. To deal with the faltering financial system, analysts have proposed several, possibly complementary, strategies. One is to inject additional equity into institutions, perhaps by continuing the Capital Purchase Program under the TARP. This approach was widely supported by economists, primarily on the ground that it would give the banking system the capacity to absorb further losses and continue making loans without requiring the Government to set a price for particular troubled assets.

Unfortunately, the extent of losses and the fog of uncertainty surrounding who exactly has suffered losses and to what extent may mean that broad-based equity injections are not the most cost-efficient way to continue to address the problems.

Therefore, another strategy is to address the troubled assets directly. This could be accomplished in several ways: by the Government buying assets, by the Government guaranteeing assets, or by the Government facilitating a division of assets into so-called good banks and bad banks. Any of these steps could help to clarify the true condition of banks' balance sheets by removing the difficult-to-value assets, and by removing those problems, help bank managers to focus on new loans rather than old problems.

The key disadvantage of this set of approaches that focus on troubled assets is that it requires the Government to set a price for buying the asset or for a guarantee.

Yet another complementary strategy is for the Government to increase its own lending to households and businesses. This could in-

clude new programs or expanding existing programs, such as the Federal Reserve's commitments to buy mortgage-backed securities and consumer loan-backed securities. The essential idea here is simply to provide public credit until the financial system is sufficiently healed to provide enough private credit.

To deal with the problems of mortgage foreclosures, the Government again could take different approaches. One is to subsidize mortgage modifications to make mortgages more affordable to borrowers holders. For example, the Government might help pay to write down mortgage principal or to reduce mortgage interest rates. The two principal challenges here are that mortgage forbearance—modifying mortgages for people in need—will encourage additional defaults. And the second problem, these sorts of subsidies are likely to be very expensive.

Another approach under consideration is to reform bankruptcy law. This would lead to more modifications at little Government expense, but the reform of bankruptcy might also crimp the future supply of mortgage credit.

Yet a third possibility is for the Government to reduce mortgage interest rates broadly. This would help both people trying to refinance unaffordable mortgages and new homebuyers trying to obtain mortgages.

The Federal Reserve has acted, as I said, over the last several months to buy mortgage-backed securities. That has helped to bring down mortgage rates, as I mentioned, but more could be done in this area.

Let me just sum up by saying that economists and financial experts widely agree that the financial markets are likely to remain severely stressed for some time, and additional action is desirable now to promote their recovery and, hence, the economy's return to vigorous growth.

Thank you. I am happy to take your questions.

[The prepared statement of Mr. Elmendorf follows:]

Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

Addressing the Ongoing Crisis in the Housing and Financial Markets

before the
Committee on the Budget
United States Senate

January 28, 2009

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Wednesday, January 28, 2009. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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

Chairman Conrad, Senator Gregg, and Members of the Committee, I welcome the opportunity to discuss the turmoil in our nation's housing and financial markets and some options for additional action by policymakers.

A strong financial sector is a necessary component of a robust economy. Financial markets and institutions channel funds from savers to borrowers who need the money to build businesses and hire workers and to buy homes and other goods and services. Indeed, credit is often required to support the ordinary operations of businesses—for example, to finance their inventories and to meet payrolls before payments are received. If the customary means of obtaining credit break down, the disruption to households' and businesses' spending can be severe.

Thus, the ongoing crisis in the U.S. financial system has significantly depressed economic activity during the past year and a half, and it poses a serious threat to the nation's ability to quickly return to a path of solid economic growth. Losses on mortgages, on assets backed by mortgages, and on other loans to consumers and businesses, together with an associated pullback from risk taking in many credit markets, have raised the cost and reduced the availability of credit for borrowers whose credit ratings are less than the very highest. To be sure, among the fundamental causes of the crisis was the provision of too much credit at too low a price as well as insufficient capital. However, the sudden shift to a much higher price for risk taking has led to a significant reduction in wealth and borrowing capacity; it has also forced a number of financial institutions to close and others to be merged with stronger operations. Those forces, in turn, are weighing heavily on consumption, the demand for housing, and businesses' investment.

Policymakers have responded to the turmoil with a set of unprecedented actions. Thus far, a systemic collapse of the financial system has not occurred, and conditions have improved noticeably in some financial markets. Nevertheless, according to some analysts, U.S. banks and thrift institutions could be facing more than $450 billion in additional estimated losses on their assets—on top of the approximately $500 billion that has already been recognized. The scale of those losses suggests that many financial institutions and markets will remain deeply troubled for some time, which will keep borrowing exceptionally costly for many borrowers and thereby dampen spending by households and businesses.

Challenging conditions seem likely to persist for some time in the housing and mortgage markets as well. Housing sales remain weak, and construction activity continues to decline. With the housing market's large glut of vacant properties, the prices of homes are likely to fall considerably further, pushing the value of more borrowers' homes below the value of their outstanding mortgages. As more of those "underwater" borrowers experience losses of income during the current recession, rates of delinquency and foreclosure on residential mortgage loans are likely to rise further.

A crucial and challenging question for policymakers is, What further actions can be taken to normalize the financial and housing markets so as to spur economic activity? A separate but equally important question—though not one considered in this

testimony—is, What can policymakers do to reduce the risk of a financial crisis in the future?

I will make four major points in this testimony:

- Turmoil in the housing and financial markets is likely to continue for some time, even with vigorous policy actions and especially without them.
- Most economists think that to generate a strong economic recovery in the next few years, further actions to restore the health of the housing sector and the financial system are needed.
- An effective policy to ensure the availability of credit for qualified borrowers probably requires a multifaceted strategy that uses a range of tools to address the different aspects of financial distress.
- The costs to federal taxpayers of actions to reduce mortgage foreclosures and improve financial conditions are highly uncertain and may be large, but the economic consequences of doing nothing may be even greater.

The Economy's Continuing Financial Problems

The vigorous monetary and financial policy actions of the past year and a half represent a graduated response to the unfolding crisis.[1] When the first signs of financial turmoil emerged, it was not clear either to policymakers or to most other observers just how serious the crisis would become. The Federal Reserve first began to supply additional liquidity to credit markets in August 2007 as pressures from losses on mortgage-related assets unexpectedly began to mount. In the following year and a half, the central bank greatly increased the funds it was providing by creating a number of new lending facilities to address emerging problems among financial institutions and in certain markets (such as those for commercial paper, money market mutual funds, and mortgages). It also expanded arrangements (known as currency swaps) to provide U.S. dollars to a number of foreign central banks and slashed the federal funds rate, which banks charge each other for overnight loans of their monetary reserves, almost to zero by late last year.

Policymakers also took a series of significant steps to prevent the problems with solvency that a number of major financial institutions were experiencing from further destabilizing markets.

- The Federal Reserve, in consultation with the Department of the Treasury, facilitated the sale of the investment bank Bear Stearns to the commercial bank JPMorgan Chase, in March 2008, by lending $29 billion to a newly formed limited liability company (LLC), Maiden Lane, against a $30 billion portfolio of Bear

1. Tables 1 through 3 on page 26 describe those actions in more detail.

Stearns's less liquid assets. (An LLC, like a corporation, offers protection from personal liability for debts incurred by a business.)

- The Federal Housing Finance Agency (FHFA)—the regulator of Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks—put Fannie Mae and Freddie Mac into conservatorship, and the Treasury provided an initial pledge to inject up to $100 billion of capital into each of the institutions by purchasing an equity share, or ownership interest, in each company.[2]

- The Federal Reserve extended a $60 billion line of credit to the insurance company American International Group (AIG). Additionally, the Federal Reserve Bank of New York arranged to lend up to $52.5 billion to two newly formed LLCs to fund purchases of residential mortgage-backed securities and collateralized debt obligations from AIG's securities portfolio.

- The Emergency Economic Stabilization Act of 2008 (Division A of Public Law 110-343) created the $700 billion Troubled Asset Relief Program (TARP), which began purchasing preferred stock of commercial banks in late October. (Preferred stock refers to shares of equity that provide a specific dividend to be paid before any dividends are paid to common stockholders and that take precedence over common stock in the event of a liquidation.) The law also temporarily raised the ceiling on deposit insurance from $100,000 to $250,000 per depositor.

- The Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) jointly announced agreements with Citigroup and Bank of America to provide each with a package of asset guarantees, access to liquidity, and capital.

- The FDIC created the Temporary Liquidity Guarantee Program in October 2008 to strengthen confidence and encourage liquidity in the banking system. The program guarantees certain newly issued unsecured debt of banks, thrift institutions, and certain holding companies and provides full deposit insurance coverage for certain checking and non-interest-bearing deposit accounts, regardless of dollar amount.

The actions mentioned above have improved conditions in some financial markets and thus far reduced the risk of a financial meltdown. The interbank market for short-term loans, which had virtually seized up, has improved markedly in recent months, as indicated by the spread, or difference, between the interest rates banks pay to borrow from each other and their expectations about the federal funds rate. (The

2. Fannie Mae and Freddie Mac were originally created as federally chartered institutions but were privately owned and operated. Designed to facilitate the flow of investment funds, they pool mortgages purchased from mortgage lenders and sell them as mortgage-backed securities, collecting annual guarantee fees on the mortgages they securitize. Conservatorship is the legal process in which an entity is appointed to establish control and oversight of a company to put it in a sound and solvent condition.

spread reflects the risk that banks will not repay the loan.) That spread can be measured by the difference between the key interbank lending rate, the three-month Libor (the London interbank offered rate), and the average expected federal funds rate over the next three months.[3] The spread has fallen to about 1 percentage point, which is roughly where it was before the failure of the investment bank Lehman Brothers (though still well above its historical norm) and well below its peak of 3.6 percentage points in October 2008. Transactions in the interbank market for short-term loans have picked up, and loans are being extended to somewhat longer terms than those seen recently, signaling that the crisis of confidence among financial institutions is continuing to ease.

Conditions have also improved in the market for commercial paper, as indicated by a smaller spread between the interest rate on commercial paper and the rate on three-month Treasury bills. (Commercial paper is a kind of short-term borrowing that provides credit to financial and nonfinancial firms.) The spreads for commercial paper that represents higher-quality credit have fallen substantially; in the case of paper with the highest credit rating, spreads have returned to the levels observed before September 2007—that is, before the financial crisis began to emerge. Moreover, the amount of commercial paper issued by financial firms has mostly recovered after a sharp decline last fall (the amount of nonfinancial commercial paper has changed little during the crisis).Those improvements, however, do not imply that private lending has returned to normal; rather, the Federal Reserve has provided extensive financial support to this market, particularly for paper that carries longer maturities, whose spreads remain elevated. Indeed, the amount of outstanding asset-backed commercial paper has yet to recover from the sharp drop that occurred in September 2007, and markets for lower-quality commercial paper no longer extend beyond a 90-day maturity.

Credit difficulties are much more severe for companies with low credit ratings. Firms' issuance of investment-grade (high-quality) debt was robust in the fourth quarter of 2008, and the interest rates that AAA-rated firms—those with the highest credit ratings—are paying to borrow money are 2 percentage points lower than at the height of the crisis, in October. (The spread of the AAA rate over the interest rate on 10-year Treasury notes nevertheless reached historic highs at the end of last year, indicating that the convulsions in financial markets and the recession have affected the cost of credit even for firms with the highest credit rating.) Conditions are more difficult for firms that have lower credit ratings—there has been little issuance of below-investment-grade debt. In addition, spreads on junk bonds have widened since September 2008, in part reflecting the difficulties that continue to beset the economy.

Although some financial conditions have improved significantly since September and October of last year, the flow of credit from banks remains constricted. A recent study showed that apart from preexisting lines of credit, bank lending to large borrowers

3. The Federal Reserve attempts to achieve a target value of the federal funds rate in its conduct of monetary policy. The expected federal funds rate is measured by the overnight index swap contract.

dropped sharply during the September-to-November period.[4] Moreover, the senior loan officer opinion survey conducted by the Federal Reserve in October 2008 shows that banks continued to tighten lending standards and terms in the third quarter of 2008. About 80 percent of large banks tightened lending standards for commercial and industrial loans, an important source of credit for investment.[5] In addition to their applying more rigorous standards for borrowers to qualify for such loans, more than 90 percent of banks (on net) raised their interest rates on commercial and industrial loans relative to their cost of funds.

Lending standards for mortgages have tightened as well, with 100 percent of the respondents in the Federal Reserve's October survey saying they were applying more rigorous standards to subprime loans (loans made to borrowers with low credit scores or other impairments to their credit histories), 90 percent saying they had tightened standards on nontraditional mortgages (such as alt-A loans, which are riskier than prime loans), and 70 percent reporting having tightened standards for prime borrowers (those considered least at risk of default). In light of the past excesses in mortgage lending, some tightening in standards had been expected. Since October, interest rates on jumbo mortgages (generally loans of more than $417,000) and on conventional 30-year mortgages have fallen, but the spreads between those rates and the interest rate on 10-year Treasury notes rose. Those spreads fell in January, however, due in part to the Federal Reserve's actions to support the mortgage market (discussed later).

Lenders have also tightened standards and terms for consumer loans. In the third quarter of 2008, 58 percent of respondents to the Federal Reserve's survey reported tightening standards on credit cards, compared with 67 percent reporting such tightening in the second quarter. Interest rates on credit cards have begun to move down modestly over the past several months, but given the much lower Libor rates, the interest rate spread has, in fact, widened.

Tighter standards for lending, declines in employment, and a large drop in consumer confidence have contributed to a marked slowing in the growth of consumer credit. By November 2008, the amount of consumer credit had grown by only 2¼ percent relative to the amount in November 2007, compared with growth of more than 5½ percent in the previous year. Much of the slowdown in growth in the past year occurred after July 2008, when the financial turmoil began to intensify.

Continuing declines in house prices and the ongoing recession are likely to worsen the financial condition of banks. Delinquency rates on residential mortgage loans continued to rise through the third quarter of last year (the latest available data), and foreclosure rates have remained high. Delinquency rates on commercial real estate loans and consumer installment loans at commercial banks have also risen sharply over the same

4. Victoria Ivanova and David Scharfstein, "Bank Lending During the Financial Crisis of 2008" (working paper, Harvard Business School, December 15, 2008).

5. Board of Governors of the Federal Reserve System, *The October 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices* (November 2008).

time span. According to the latest compilation by the Bloomberg financial information network, financial institutions worldwide have recognized losses of about $1 trillion since the third quarter of 2007, primarily because they held securities based on residential real estate. Analysts with Goldman Sachs estimate that banks worldwide are likely to experience about another $1 trillion in losses on residential mortgages, loans on for commercial real estate, credit cards, auto loans, commercial and industrial loans and corporate bonds.[6]

In an attempt to deal with such losses, financial institutions have been reducing their leverage—that is, their use of borrowed funds—by holding a greater amount of capital in relation to their assets. In 2007 and early 2008, many banks seemed to have little difficulty in deleveraging because they could obtain additional capital from private sources through offerings of common and preferred stock. As the solvency of more and more financial institutions has been tested, however, those private sources of capital appear to have dried up.[7] (Another way to increase capital would be to cut dividends, but most banks are reluctant to do so because that could deter new and existing shareholders from holding the stock.) The interventions by the Treasury and the Federal Reserve in the past several months have been largely directed toward counteracting the contraction of credit that results from banks' deleveraging. The Federal Reserve, through its holdings of assets and by direct lending (for example, in the commercial paper market), has provided credit that private institutions previously would have provided. In addition, most of the first half of the $700 billion in TARP funding has been used to supply banks directly with capital.

The Need for a Multifaceted Strategy to Address the Financial Crisis

Economists and financial experts widely agree that the financial markets are likely to remain severely stressed for some time and that additional action is desirable now to promote their recovery and hence the economy's return to more vigorous growth. With the economy weakening, losses on loans are likely to continue to deplete the capital of financial institutions for the foreseeable future. Such conditions raise the prospect of a vicious cycle of loan losses, leading to further reductions in the availability of credit, weaker economic activity, more loan losses, and so on. Stimulus from fiscal policies can strengthen the economy and, as a result, complement policies directed specifically at strengthening the financial sector.

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6. See Jan Hatzius and Michael Marschoun, *Home Prices and Credit Losses: Projections and Policy Options*, Goldman Sachs Global Economics Paper 177 (New York: Goldman Sachs, January 2009).

7. Because new capital would largely help to shore up balance sheets, new investors would expect existing shareholders to accept a dilution of their ownership. Existing shareholders would rather take the gamble of not raising new capital than suffer an immediate reduction in wealth. Economists refer to that reluctance of distressed firms to raise equity capital as a "debt overhang" problem.

Many analysts agree that a broader, clearer strategy is necessary to help return the flow of credit to a more normal state and support the recovery of overall economic activity. Some critics of the actions taken to date say those interventions have been confusing to markets and have given the impression that the government is "playing favorites" (because different forms and amounts of support have been given to different financial institutions).[8] Private investors are chary of providing capital to banks in part because of uncertainty about banks' financial positions and future government actions. Moreover, banks may be postponing actions to resolve their financial problems in anticipation of receiving additional support from the government. Therefore, one advantage of a more clearly enunciated strategy would be that financial markets would be more certain about future policy steps.

Principles for Crafting a Strategy

Several principles can be used to craft a sound strategy for further assisting the recovery of the financial markets:

- Effective strategies would have some degree of flexibility so actions can be adjusted to changing and unexpected circumstances. There is enormous uncertainty not only about the future course of this crisis but also about its impact on economic activity, the degree of success that might be expected from different policy actions, and the amount of resources to devote to those actions. A degree of flexibility would allow policymakers the leeway to shift gears so as to regain traction in a crisis that might continue to unfold in unexpected ways. Flexibility that is governed by principles that are understood by the private sector could reduce uncertainty about the government's interventions, which can freeze actions by the private sector.

- A sound strategy would determine an appropriate price for the assistance given to financial institutions. Such pricing should give financial institutions an incentive to solve their problems on their own if they are in a position to do so and should mean shuttering institutions that have little prospect of recovery. Underpricing the support would profit creditors, executives, or workers in the financial system at the expense of taxpayers. As a result, it would increase the likelihood that they would continue to take excessive risks in the future or become too large and important an institution to be allowed to fail (a phenomenon known as moral hazard). However, overcharging would delay the system's and the economy's recovery.

- An effective strategy would encourage the participation of private capital. Having a role for private capital is important both because the government cannot provide enough money itself and because private market signals regarding the long-term viability of specific institutions can be valuable. Encouraging private capital means

8. See Shadow Financial Regulatory Committee, *An Open Letter to President-Elect Obama*, Statement No. 264 (Washington, D.C.: American Enterprise Institute, December 8, 2008), available at www.aei.org/docLib/20081208_StatementNo.264.pdf; and Luigi Zingales, "Yes We Can, Mr. Geithner," available at www.voxeu org/index.php?q=node/2807.

not only that the strategy must provide clear guidance, but also that it must avoid as much as possible a lack of clarity and especially incentives that encourage private capital to sit on the sidelines and wait for government to act.

- As the financial system is rebuilt, private creditors will have to take some losses; and some banks may have to fail: It is neither necessary nor desirable for government to take on all the losses from bad assets.

- An efficient strategy would distort the supply of credit as little as possible. Distortions could arise, for example, if policies picked winners and losers—that is, if they treated financial institutions in similar circumstances differently or focused on certain types of credit at the expense of others with similar needs.

- A sound strategy would coordinate the activities of government agencies (including the Federal Reserve, the Treasury, the FDIC, the FHFA, and the Securities and Exchange Commission) to avoid overlapping actions and initiatives that operate at cross purposes.

- A successful strategy would be implemented quickly to reduce the chances of a vicious cycle of losses on loans, reductions in the availability of credit, weaker economic activity, more loan losses, and so on.

Evidence from Other Crises

Previous financial crises in the United States and other countries highlight the risks and greater costs that come from implementing only partial measures in the hope that time and economic growth will quickly resolve problems in the banking system.

The savings and loan crisis in the United States in the late 1980s illustrates the costs of delaying action. The ultimate cost to taxpayers for cleaning up the thrift crisis was estimated to be about 2 percent of gross domestic product (GDP), and an analysis by the Congressional Budget Office (CBO) found that delays in closing and resolving insolvent thrifts doubled the costs to taxpayers.[9,10] At the time of the crisis, some regulators thought that the problems facing the thrift institutions were temporary and that, given time, the institutions could be restored to solvency through the profits gained in their operations and a recovery in the value of their assets. In effect, though, that forbearance by regulators led many insolvent institutions to take greater risks in the hope of becoming solvent, a phenomenon known as "gambling for resurrection." Because most of their deposits were federally insured, the institutions could acquire additional funds to make speculative investments by offering somewhat higher interest rates than solvent institutions had to pay. In the end, the costs to taxpayers spi-

9. Timothy Curry and Lynn Shibut, "Costs of the Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review* (2000).

10. Congressional Budget Office, *The Cost of Forbearance During the Thrift Crisis* (June 1991). Note that the costs cited for resolving previous financial crises are generally stated in cash terms.

raled, eventually resulting in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the creation of the Resolution Trust Company.

Financial conditions in Japan in the 1990s were probably closer to current conditions in the United States. In the 1980s, Japan experienced both stock market and real estate bubbles that by 1992 had burst. Initially, Japanese authorities encouraged the formation of private asset management companies that would purchase troubled assets from banks, but as the financial problems deepened, public funds were also used to purchase assets. In 1997, a credit crisis began with the bankruptcy of a major bank and a securities firm. Like the United States, Japan faced highly elevated interbank lending rates after those events, reflecting a lack of confidence in its financial institutions. In the midst of the crisis, the government changed the accounting rules governing banks' financial statements, allowing banks to choose whether to value assets at their historical book value or to use "mark-to-market" accounting.[11] As a result, Japanese banks could report earnings using the accounting method that was more favorable to them. Using the book value of assets also gave Japanese banks an incentive to offer additional credit to troubled borrowers rather than to healthier firms "to avoid the realization of losses on their own balance sheets."[12] Furthermore, as was the case during the U.S. thrift crisis, regulators allowed and even encouraged the practice of forbearance.

By late 2002, Japan had finally begun to address the problems caused by forbearance, and its regulators were pressuring banks to improve their balance sheets. Japan's financial sector improved, but whether the more effective regulation of banks or the global economic boom that began in 2003 had the greater impact is difficult to determine. The costs associated with the rescue of Japan's financial system have been estimated at about 25 percent of GDP.[13]

The lack of support provided to the financial system during the Great Depression differed from the policy of forbearance that characterized the U.S. thrift crisis and Japan's financial turmoil, and some economists view that laissez-faire approach to the widespread bank failures that occurred during the Depression as an example of being too strict. According to Federal Reserve Chairman Ben Bernanke, policymakers thought at the time that "to weed out weak banks was a harsh but necessary prerequisite to the recovery of the banking system."[14] By contrast, in Bernanke's view, the Federal

11. Takeo Hoshi and Anil Kashyap, "*Will the U.S. Bank Recapitalization Succeed? Lessons From Japan*," NBER Working Paper 14401 (Cambridge, Mass.: National Bureau of Economic Research, December 2008)

12. Joe Peek and Eric Rosengren, "Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan," *American Economic Review*, vol. 95 (2005).

13. See Luc Laeven and Fabian Valencia, "*Systemic Banking Crises: A New Database,*" IMF Working Paper WP/08/224 (Washington, D.C.: International Monetary Fund, November 2008), and Anil Kashyap, "Sorting Out Japan's Financial Crisis," *Federal Reserve Bank of Chicago Economic Perspectives*, vol. 26 (2002, Fourth Quarter)

14. Ben S. Bernanke, "Money, Gold, and the Great Depression" (remarks at the H. Parker Willis Lecture in Economic Policy, Washington and Lee University, Lexington, Virginia, March 2, 2004).

Reserve should have increased the monetary base either by supplying more funds to banks or by increasing the currency in circulation to limit the adverse effects of bank failures on borrowers and depositors. Those funds could then have been used to pay off depositors and curtail runs on banks.

A more successful outcome emerged from the response of Swedish policymakers to the financial crisis of 1992, which came on the heels of a speculative bubble in Swedish real estate. By 1991, the cost of the reunification of Germany had caused interest rates in Europe to increase sharply. In addition, international growth was slowed by a recession in the United States, and the combination of those factors led Sweden's real estate bubble to burst. The steep decline in the value of real estate in turn impaired the value of the assets held by many Swedish banks. The crisis was exacerbated by attempts to defend Sweden's currency: Sweden's central bank, the Riksbank, let overnight rates rise as high as 500 percent to prevent the outflow of the Swedish currency. In that difficult environment, Sweden's economy fell into recession, and banks' losses increased rapidly.

The Swedish government insisted that banks value loans and assets on their balance sheets using mark-to-market accounting standards.[15] Under those rules, the values prevalent in the financial markets were applied, even though many participants believed that the current conditions in those markets temporarily understated the values of the assets. That policy led to large losses for the banks, but authorities considered such a policy necessary to restore confidence in the financial system. After the banks' assets were marked to market, banks identified as having good prospects for surviving were helped, and the rest were either merged with stronger banks or liquidated.

As was the case in the savings and loan crisis in the United States, Sweden formed asset-management companies to deal with the assets from the liquidated banks. No measures were adopted to support nonfinancial companies, and the number of bankruptcies rose markedly. Sweden placed limits on the Riksbank in its dealings with the banks, basically allowing the central bank only to provide liquidity and not to take risks with taxpayers' funds. Sweden's financial sector began to recover about a year after the crisis reached its peak, in late 1993, at a cost of about 4 percent of its gross national product.

The experiences of previous financial crises highlight the risks to nations' economies and the costs to taxpayers when governments delay action to bolster their financial systems in the hope that economic growth will resolve banks' problems. Of course, some cases could be cited in which global economic growth has allowed financial systems to recover without special government action. Yet once the problems of such systems became as severe as in the United States' current situation, economists and financial experts generally agreed that additional action was desirable to promote a system's

15. See Lars Heikenstein, Deputy Governor, Risbank, "Financial Crisis—Experiences from Sweden" (speech in Seoul, Korea, July 15, 1998).

recovery. Successful approaches have entailed forceful action by government authorities to uncover the true financial condition of each bank, to close banks in the worst shape, and to provide support to banks that appear viable in the long run.

Possible Elements of a Rescue Strategy

Several complementary approaches might be used to further assist the recovery of the financial system. Some extend or continue current interventions; others attack the crisis from different angles.

Inject More Equity into Financial Institutions. The government could further strengthen the financial system by taking a larger ownership interest in some financial institutions through the purchase of more equity. That could be accomplished by continuing the Capital Purchase Program (CPP) under the TARP, an approach that was widely supported by economists when it began. In the eyes of some observers, the government's further purchases of equity in banks would bring the government closer to nationalizing a major portion of the banking system. However, additional purchases may be appropriate if conditions in the financial markets worsen.

The main advantage of this approach is that it would provide banks with a greater capacity to absorb further losses, which would help stabilize the banking system and in so doing support banks' lending. Another advantage of injecting equity is that it would maintain existing channels of borrowing and lending. Such channels cannot be created overnight, and the use of existing pathways would allow lending to pick up again more quickly.

Some observers have criticized the CPP because they believe that banks that have received money from the equity purchases have not increased their lending sufficiently. That criticism is difficult to evaluate because it is very hard to trace the use of particular funds in large and complex banks, and it is very hard to know what bank lending would have been in the absence of equity injections by the TARP. In addition, many banks currently have good reason not to boost lending. To the extent that they need to reduce their own leverage, they can do that either by lending less or by getting more capital. The government's capital injection may thus mean that banks do not have to cut their own lending as much, but that may not mean they can actually increase lending. Moreover, even without the need to delever, the slow growth of lending reflects banks' unwillingness to increase risky lending in the current recession or a lower demand for borrowing as a result of the slowdown.

A further criticism of the CPP is that it is purchasing equity from banks at very favorable terms for the banks. The program requires all banks to pay a dividend of 5 percent on the government's preferred shares for the first five years—even though banks that have other outstanding preferred shares currently pay the owners of those shares a higher dividend. Moreover, the subsidy that the government's purchase represents varies by bank, because it depends on the market's assessment of the riskiness of investment in the bank.

Injecting more equity into financial institutions raises the risk of propping up banks that should be allowed to fail. By supporting weak banks, the government may be allowing them to take excessive risks in hopes of resurrecting themselves. If they are successful, they stay in business; if they are not successful, their mistakes are paid for by the federal deposit insurance system or by taxpayers.

Government equity injections are, moreover, unlikely to be sufficient to fill all the capital needs of banks if they are to provide a level of lending that is sufficient for a growing economy after the recession ends. Policy therefore needs to be designed to encourage private investors to supply some of the new capital. A clear, principled policy can reduce the incentive for private investors to sit on the sidelines, waiting to see how much money the government will commit and which institutions will be supported.

One possible approach to determining which banks should receive funds and the price they should pay for them, while at the same time encouraging private participation in recapitalization, would be to match the government's equity contributions or loans to private equity purchases. The involvement of private investors would solve the pricing problem because they would inject capital into firms only on terms that provided an adequate return on their investment. Policymakers could require that any injections of public capital be matched by private investors' equity purchases and that the dividend rate that banks pay on their new public capital equal the rate they must pay on the new private capital. In that way, taxpayers would receive a return on their investment that more closely reflected the risks they were assuming. However, the management and shareholders of distressed firms are unlikely to agree to take equity infusions without some federal subsidy because the injection of new equity capital on market terms usually benefits the firm's debtholders at the expense of its shareholders.[16]

Address Troubled Assets. The government could facilitate the removal of troubled assets from the balance sheets of some institutions. Such a removal could clarify the true value of institutions' balance sheets by removing the difficult-to-value assets from some institutions and by establishing a market price that other institutions could use in their own valuations. That step might improve the solvency of some institutions by establishing a price for troubled assets that exceeds both the value of those assets on the institutions' books and the price that investors are currently willing to pay for them. That would leave those institutions in a better position to raise capital and make new loans. At the same time, establishing a market price could force some institutions to recognize losses, because of the accounting rule that most assets held for sale must be marked to market. Moreover, removing troubled assets would allow the managers of financial institutions to focus on new lending rather than on cleaning up previous mistakes.

16. That phenomenon is termed the "debt overhang" problem (see, for example, S. Myers, "Determinants of Corporate Borrowing," *Journal of Financial Economics*, vol. 5 (1977).

One approach that is currently much under discussion is to set up an "aggregator bank" that would purchase risky assets that are not actively traded from troubled institutions and then dispose of them, leaving the balance sheets of the banks clean so that they could then return to lending. That is similar to Sweden's approach, described earlier.

The first problem to be encountered is how much to pay for those assets. Because they are not actively traded, the assets do not have readily observable market values. Paying too much would help recapitalize the banks, but it would reward risky behavior and leave taxpayers with a large bill from the losses on the assets. Erring on the low side—such as by buying assets at fire-sale prices—would run the risk of forcing banks to mark down the assets to unrealistically low prices, making more banks insolvent than perhaps needed to be.

As with capital injections, the government could partner with private investors to determine a market price for asset purchases. In that case, the government could partially finance (through loans) the purchase of troubled assets by private investors. Because the investors' profits would depend on accurate pricing, they would help determine the assets' fair market prices. The government would not finance the full cost of the purchases so that private investors would have to put up—in essence, risk—some of their own money for the transaction. The government could help protect taxpayers' money in a number of ways: by requiring that the private investors take losses before the government, by holding the purchased assets as collateral, or by using recourse arrangements for the loans (essentially collateralizing the loan with the investors' other assets). However, without some federal subsidy, private investors might find few willing sellers of such assets.

Alternatively, instead of buying assets, the government could guarantee portfolios of assets; that is, provide insurance against some losses on the assets. An asset guarantee would shift the risk of loss from the financial institutions to the federal government, just as if the government had taken direct ownership of the troubled assets. With guarantees in place, financial institutions would more easily borrow and raise capital. Determining the price of the guarantee would not be easy, and the government could experience large losses if the price was too low, or fail to attract participation if the price was too high.

Yet another approach, known as "good bank/bad bank," tries to isolate troubled assets in a different way. An existing bank that has a large amount of troubled assets is split into two new banks—one (a "good" bank) with all of the good assets and lending operations and the other (a "bad" bank) with all of the bad assets.[17] Mellon Bank

17. Chairman Ben S. Bernanke, "The Crisis and the Policy Response" (the Stamp Lecture, London School of Economics, January 13, 2009). See also Zingales, "Yes We Can, Mr. Geithner." Zingales also proposes a prepackaged bankruptcy option that would allow banks to restructure their debt and restart lending. He describes that option in fuller detail in "Plan B," *The Economists' Voice* (October 2008), available at www.bepress.com/ev.

used that approach to deal with its soured energy and real estate loans (without government support) in 1988, and the Swiss government used it last year to deal with the problems of the bank UBS. This approach essentially forces the stockholders and creditors of the bank to absorb the losses from the bad assets while creating a new bank with a clean, transparent balance sheet that should be able to borrow and lend in a normal way. In principle, that approach does not require government funds, although as a practical matter, such funds may well be necessary.

Dividing assets and putting them into separate entities has the advantage of providing greater clarity and less uncertainty about the financial health of the new good banks than are offered by the more subtle approaches of guarantees or selective asset purchases. Consequently, the good banks would be more willing to lend to each other (although there might be some reluctance if the existing management team remained in place) and more able to raise new capital from private investors to support new lending. Because this approach would effectively quarantine the bad bank away from the greater financial system, the approach would also allow for a more orderly liquidation of the bad bank's assets. Such a process would probably obtain higher prices for the assets than those achievable through a fire-sale liquidation.

However, even though Mellon Bank managed to split itself into a good and a bad bank in 1988, many securities lawyers are skeptical that similar splits could be accomplished now without government support or perhaps legislation, because of the competing interests of debt and equity holders. Those competing interests could come into play because some ways of accomplishing the split could favor stockholders over creditors by allowing stockholders a share of profits in the new good bank.

Approaches that inject capital and purchase troubled assets could be used together. The government could pay market prices for the assets and then help banks cover their losses through a program of capital injections. In that way, the prices of the assets would not be distorted, but the banks would receive some assistance. That approach, however, has the disadvantage of potentially providing the most government capital to the banks that made the worst business decisions and therefore have the greatest volumes of toxic assets on their balance sheets.

Provide Credit Directly. The government could increase its direct lending to consumers, homeowners, and businesses by expanding existing programs or starting new ones. That approach would increase the availability and lower the cost of credit for those borrowers.

For example, the Federal Reserve could expand its Term Asset-Backed Securities Loan Facility (TALF). The TALF is designed to help participants in the market meet the credit needs of households and small businesses by supporting the issuance of asset-backed securities that are collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. The TALF is expected to begin lending in February 2009; at that point, the Federal Reserve Bank of New York will lend up to $200 billion on a nonrecourse basis to holders of certain AAA-rated

securities that are backed by newly and recently originated consumer and small business loans. The Federal Reserve Bank of New York will lend an amount that is less than the market value of the securities; the loans will be secured at all times by those securities. The Treasury—under the TARP—will provide $20 billion of credit protection to the Federal Reserve Bank of New York in connection with the TALF. The Federal Reserve could expand the TALF by buying securities backed by other types of assets, such as mortgages on commercial properties.

The Federal Reserve also could expand its Commercial Paper Funding Facility (CPFF), which is designed to provide a liquidity "backstop" to U.S. issuers of commercial paper. The CPFF is intended to improve liquidity in short-term funding markets and thereby contribute to greater availability of credit for businesses and households. Under the CPFF, the Federal Reserve Bank of New York finances the purchase of highly rated unsecured and asset-backed commercial paper from eligible issuers via primary dealers.[18] In expanding the facility, the Federal Reserve could purchase more paper from eligible issuers and expand the program to include lower-rated paper.

Another alternative would be for the government to attempt to broadly lower the cost of mortgage loans. In lowering the cost of borrowing, such a program would raise the demand for houses, but it would be unlikely to boost house prices significantly, given the large overhang of vacant houses. Programs of that kind would also help reduce unnecessary foreclosures by increasing opportunities to refinance unaffordable loans.

Several programs are already in place to lower the cost of prime conforming loans (loans of up to $417,000—higher in high-cost areas—that are eligible to be purchased by Fannie Mae and Freddie Mac).

- The Housing and Economic Recovery Act of 2008 authorized the Department of the Treasury to buy obligations and securities issued by Fannie Mae and Freddie Mac. About $70 billion of residential mortgage-backed securities had been purchased as of December 31, 2008.

- Over the next several quarters, the Federal Reserve, through competitive auctions, will purchase up to $100 billion in debt issued by the three government-sponsored enterprises for housing—Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.[19]

- Over the next several quarters, the Federal Reserve will purchase up to $500 billion in mortgage-backed securities issued by Fannie Mae, Freddie Mac, and the Government National Mortgage Association (Ginnie Mae).[20]

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18. Primary dealers are firms that trade in U.S. government securities with the Federal Reserve System. There are currently 17 primary dealers.

19. Unlike Fannie Mae and Freddie Mac, the Federal Home Loan Bank System, which provides low-cost loans to home mortgage lenders, has not been taken over by the government.

20. Ginnie Mae, a government-owned corporation, guarantees securities backed by federally insured or guaranteed loans, mainly loans insured by the Federal Housing Administration or guaranteed by the Department of Veteran Affairs.

The government could begin a similar program to help thaw the market for jumbo mortgages and stimulate originations of jumbo loans. Under such an approach, the government could purchase securities that are backed by jumbo loans either directly or through Fannie Mae and Freddie Mac.

Policymakers have also worked to improve the supply of student loans. In May 2008, lawmakers enacted Public Law 110-227, the Ensuring Continued Access to Student Loans Act, which allowed the Department of Education to offer buyer- and lender-of-last-resort programs to lenders in the Family Federal Education Loan Program (or FFELP). Lenders in the FFELP program, who finance the loans they make to students in private capital markets (with federal assistance), have seen their financing costs increase sharply since the financial market turmoil began.Under the new programs, which apply to loans issued before July 1, 2010, lenders may obtain temporary financing from the Education Department at attractive borrowing terms (that is, at financing rates higher than those that might be considered normal but lower than the rates they could get in the current credit markets), or they may sell their loans to the department (at close to face value). Without the additional federal assistance, those higher funding costs would have forced lenders to cut back on their lending in the 2008-2009 school year and beyond.

To date, the actions of the department have been successful in ensuring the continued availability of student loans. The Department of Education has provided temporary financing of $8.7 billion, which covers almost half of the loans originated in the 2008–2009 school year. Loans worth approximately $62 million have thus far been sold to the department under the purchase programs. In November, the Department of Education announced new programs that broadened eligibility for funding and purchases of loans to those originated before 2008. (Before that announcement, only loans that were originated in the 2008–2009 and 2009–2010 school years were eligible for purchase or financing.) Lenders may also be eligible to finance their student loans under the Federal Reserve's TALF.

Assist Troubled Businesses and Governments. As part of a broader strategy to support the overall economy rather than just the financial sector, the government could assist nonfinancial industries, as it has started to do with some of the major U.S. automobile manufacturers, whose possible failure appears likely to worsen the ongoing recession. Policymakers used some of the funds provided through the TARP to support General Motors and Chrysler and their financial arms. However, other industries have also sought assistance, putting policymakers in the position of picking winners and losers in the current economic downturn. That situation raises issues of fairness, prompting questions about why some workers and firms receive assistance but others do not. It also raises issues of economic efficiency because assisting troubled businesses could keep labor and capital from moving to other businesses and industries that might better be able to use them. That problem may not seem severe during a recession, when there are unused resources. But to the extent that businesses that would otherwise have failed are still around, and failing to thrive, after the recession,

resources will be misallocated and the productivity engine of the economy will be compromised.

Promoting Actions to Lessen the Number of Mortgage Foreclosures

The government could help mortgage borrowers and lenders, and improve conditions in the housing market, by more vigorously supporting efforts to reduce the number of avoidable foreclosures. In 2007, about 1.6 million foreclosures were initiated; the first nine months of 2008 alone saw 1.7 million foreclosures. Moreover, with house prices likely to continue to fall and with the recession pushing down family incomes, analysts expect the number of foreclosures to remain high during the next two years. (CBO expects that the prices of houses will decline by another 14 percent, and some forecasters in the private sector are looking for even bigger slides.) Some analysts are now suggesting that the prices of houses in some markets are back to or near their fundamental values; however, another possibility is that prices could overshoot on the downside by 10 percent or more.[21] Many of the coming foreclosures are unavoidable because the borrowers cannot afford a refinanced loan that would also be profitable for lenders (that is, the profits from the modified loan are less than the amount that the lender would earn through foreclosure). However, some of those foreclosures might be avoided if distressed borrowers were given the opportunity to refinance their loans on more favorable terms. If government policies do not address the foreclosure problem, the additional excess supply of houses could further push up expected mortgage losses, which already exceed $1 trillion, according to some analysts.

The benefits of preventing unnecessary foreclosures are considerable, not only for lenders and borrowers but also for the economy. The cost of a foreclosure may range from 30 percent to 60 percent of the value of a property, and by contributing to neighborhood blight, foreclosures have additional negative spillover effects on local economies. A reduction in the number of avoidable foreclosures would complement other actions to strengthen the financial sector because it would shore up the values of mortgage loans on lenders' books—although not by enough to resolve the problems with solvency in the financial system. A smaller number of foreclosures would also provide some support for house prices, but probably not enough to reverse their ongoing decline.

Modifications of mortgage loans have increased in the past year, but the approach has met with limited success—in part because a large percentage of loans that had been modified have subsequently redefaulted.[22] However, the streamlined modification

21. For example, see Hatzius and Marschoun, *Home Prices and Credit Losses*.

22. More than 37 percent of the loans modified in the first quarter of 2008 were more than 30 days delinquent after three months, and 55 percent were more than 30 days delinquent six months later. See Office of the Comptroller of the Currency and the Office of Thrift Supervision, *OCC and OTS Mortgage Metrics Report, Third Quarter 2008* (December 2008). Also see the remarks of John Dugan, Comptroller of the Currency, at the Office of Thrift Supervision's Third Annual National Housing Forum, Washington, D.C., December 8, 2008.

plan used by the FDIC to modify loans made by the failed lender IndyMac may have more success because it targets a substantial reduction in the borrower's monthly payments and repayment burden.[23]

Efforts to reduce foreclosures face a number of obstacles. Lenders are afraid that if they modify some loans, borrowers who otherwise might meet their contractual mortgage payments will ask for loan modifications as well. Lenders also may be waiting to see what mitigation strategies the government settles on. Further complicating modifications of loans in many instances are second mortgages and home-equity loans and lines of credit. When first liens are underwater—the value of the house is less than the balance on the mortgage—any second liens are almost valueless. In that circumstance, modifying the first lien—especially reducing the principal on an underwater loan—may do the borrower no good if it simply increases the value of the second mortgage. Thus, meaningful loan modification may require the cooperation of second lien holders, which can be difficult to arrange.

Modifications of loans held in "pools" that back securities face additional obstacles. (Rates of foreclosure on loans that have been held by the lenders and not securitized are about 20 percent to 30 percent lower than the rates experienced by third-party servicers.) Third-party servicers have little or no financial incentive to modify mortgages because they will not be adequately compensated for their costs. In addition, legal constraints and uncertainties in the pooling and servicing agreements for mortgage-backed securities may inhibit modifications. Servicers may be prohibited from performing modifications that improve the net returns to all investors collectively if some investors (typically those holding the lowest-priority claims on the securities' returns) are made worse off by the modification.

Consequently, a number of proposals have been advanced to overcome those obstacles. To align the incentives of servicers more closely with those of investors and borrowers, servicers could be paid a fee for each successful loan modification. Alternatively, investors could be given an incentive to be more receptive to loan modifications. Under some proposals, those fees would be subsidized by the government. Currently, Fannie Mae and Freddie Mac are increasing the payments they make for loan modifications.

Alternatively, a number of proposals would change the legal constraints that inhibit loan modifications on securitized loans. For example, one would eliminate explicit restraints on modifications and create a "safe harbor" from lawsuits in the case of modifications that raise the overall net returns to investors.[24] However, such proposals

23. The FDIC contends that systematic loan modifications can still make good business sense even with a default rate of 40 percent. See the statement of John F. Bovenzi, Deputy to the Chairman and Chief Operating Officer, Federal Deposit Insurance Corporation, before the House Committee on Financial Services, January 13, 2009.

24. Statement of Christopher J. Mayer, professor, Columbia Business School, before the House Committee on Financial Services, January 13, 2009.

might raise constitutional issues unless compensation was provided to some of the parties who lost out. And that kind of approach would require using taxpayers' money to compensate the holders of the riskiest "slices" of mortgage-backed securities.

Another important obstacle to actions to promote loan modifications is that a large number of distressed borrowers have "negative home equity"—that is, balances on their loans that exceed the homes' value. By the middle of last year, an estimated 10.5 million borrowers had a total of about $850 billion in negative home equity with an average amount of more than $75,000.[25] Those borrowers do not have the necessary equity to qualify for a refinanced loan with a private lender.[26] To address that problem, policymakers created the Hope for Homeowners program under the Federal Housing Administration (FHA) to encourage private lenders to refinance loans of borrowers with negative home equity. The FHA will guarantee new 30-year fixed-rate mortgages under the plan if the loans meet a number of criteria. One criterion, that the new loan be between 90 percent and 97 percent of the home's current appraised value, has limited lenders' interest in the program because it requires them, in some cases, to "recognize" (record on their balance sheets) a substantial loss on the original loan. To date, no modifications have been completed under this program, and the number of applications has been minimal. Reducing the size of that write-down or subsidizing it (or both) would encourage more lenders to participate, but it would also shift more costs to the government.

Other proposals for limiting foreclosures would shift more costs to taxpayers either through federal loan guarantees or direct purchases of loans and their modification by the government. For example, a proposal by the FDIC would result in the government's guaranteeing modified loans. Under the proposal's streamlined approach to modifications, modified mortgages would include a reduction in interest rates, an extension of loan terms to 40 years, and forbearance on repayment of the principal, all of which would be designed to reduce a borrower's monthly cost for housing to as low as 31 percent of his or her monthly income. If the loans subsequently redefaulted, lenders would recover up to 50 percent of the loan from the government, subject to some restrictions.

A proposal modeled after the approach taken by the Depression-era Home Owners Loan Corporation (HOLC) would have the government purchase and then refinance mortgages that were in or near default. A new agency would be created that would buy mortgages from lenders at some discount to the mortgages' book values (the values for the loans that lenders carry on their balance sheets) and then refinance them at

25. Christopher Mayer and R. Glenn Hubbard, "Home Prices, Interest Rates, and the Mortgage Market Meltdown" (working paper, Columbia University Business School, October 2008), available at www2.gsb.columbia.edu/faculty/cMayer/Papers/Mayer_Hubbard_BEP_10_2008_v7.pdf.

26. Private lenders have generally avoided writing down the principal of mortgage loans in favor of either forbearance on payment of the principal or reductions in interest rates. In part, they fear that write-downs will encourage borrowers to behave strategically to qualify; in part, they also hope that housing prices will recover in the future.

interest rates tied to the government's borrowing rates (that is, the rates on Treasury securities). Buying up all of the troubled loans, however, would require hundreds of billions of dollars, and determining prices that would provide enough protection to taxpayers would be particularly challenging. Dangers include the likelihood that the worst mortgages would be sold to the government and that a lack of funding would allow only some borrowers to be helped. Although the HOLC returned a small amount of funds to the Treasury when it was liquidated, the program was not costless to taxpayers, who were not compensated for the risks they bore. Another concern is how to target any subsidies that are offered and avoid the problem that some borrowers might be helped a great deal and others only slightly. (Tying the subsidy to the size of the mortgage, for example, would provide greater help to those with bigger mortgages.) Given the aggregate amount of negative equity, such proposals could cost the government hundreds of billions of dollars, even with the private sector absorbing a good portion of the losses.

A different approach to encouraging loan modifications would be to change federal bankruptcy laws. Bankruptcy judges could be allowed to restructure certain mortgages on principal residences under Chapter 13—for instance, by limiting a mortgage to the current value of a home (known as "cram down") or by changing the terms of a loan. Under current law, Chapter 13 halts foreclosure proceedings by lenders, giving homeowners an opportunity to restructure their financial arrangements. Although Chapter 13 currently gives courts the leeway to adjust many financial obligations, it does not generally allow the terms of a mortgage on a principal residence to be modified.[27] Changing that provision of Chapter 13 would allow bankruptcy courts to treat mortgages on a primary residence in the same way they treat secured debts on other items, such as motor vehicles, vacation homes, investment properties, and personal businesses. (In practice, bankruptcy judges seldom restructure mortgages on vacation or investment properties.)

Allowing a bankruptcy court to modify the amount or terms of a mortgage changes incentives for both borrowers and lenders. It gives borrowers an incentive to file for bankruptcy as a way to lower their mortgage payments and avert foreclosure. Consequently, lenders would have a greater incentive to restructure loans voluntarily. Lenders would also have a stronger incentive to be more prudent in making loans, which could help avoid future excesses in the mortgage markets. In doing so, lenders might raise mortgage rates, particularly for high-risk borrowers, to offset any expected additional losses from loan modifications in bankruptcy. However, some research indicates

27. 11 U.S.C. §1322(b)(2). Furthermore, the Supreme Court has held that even when the value of the debt exceeds the value of the property—a partially secured debt—courts may not modify that debt. See *Nobleman v. Am. Savings Bank*, 508 U.S. 324 (1993). Conversely, when a second (or third) mortgage is wholly unsecured because the value of the property is insufficient to satisfy the first mortgage, such subordinated debt may be discharged. *Tanner v. FirstPlus Fin. Inc.* (In re Tanner), 217 F. 3d 1357 (11th Cir. 2000) announced what has become the dominant view among the circuit courts of appeals. Hence, the claims of partially secured creditors are protected by bankruptcy law, but the claims of unsecured creditors are not.

that in the past, the terms and availability of mortgages that could be modified in bankruptcy were not too different from those that bankruptcy did not cover.[28] The increase in mortgage rates might be limited in part because lenders might also change other lending terms to reduce their exposure to losses. Changing the bankruptcy law could also add to the caseload of the bankruptcy court system.

The Budgetary Costs of the Financial Rescue

The ultimate costs of the actions taken in response to the turmoil in the financial markets are uncertain, but they could be quite large. Those costs derive from the policy actions of various parts of the government—the Federal Reserve, the Treasury, and other federal agencies. Many of the actions involve the purchase of assets or loans by the government; as a result, some portion of the current funding being directed toward the crisis (perhaps most of it) is likely to be recouped in the future. However, given the fragility of the financial sector and the riskiness of the assets being purchased or guaranteed—as well as the social purposes underlying the policy responses—the federal government can expect some net losses from its transactions. (Tables 1 to 3 contain details of those actions.)

Costs to the Taxpayer

Most of the policy actions taken in response to the financial turmoil have been more like investments than like cash outlays. Both the Federal Reserve and the Treasury have been purchasing financial instruments (for example, mortgage-backed securities) in an effort to boost liquidity in the market; at some point in the future, many of those instruments will be redeemed by their issuers or sold to other buyers. Because such investments were not made purely with the goal of making a profit, they could reasonably be expected to result in some losses.

The Federal Reserve. Activities of the Federal Reserve are not directly recorded in the federal budget. Rather, each year its net earnings—generated by interest on its holdings of securities; income from foreign currency holdings; fees received for services provided to institutions that accept monetary deposits from consumers (such as check clearing, funds transfers, and automated clearinghouse operations); and interest on

28. See Adam J. Levitin and Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets*, Business Economics and Regulatory Policy Working Paper No. 1087816 (Washington, D.C.: Georgetown University Law Center, February 6, 2008). See also Michelle J. White, *Bankruptcy: Past Puzzles, Recent Reforms, and the Mortgage Crisis*, Working Paper No. 14549 (Cambridge, Mass.: National Bureau of Economic Research, December 2008).

loans to such institutions—are remitted to the Treasury and recorded in the budget as revenues. That income is typically in the range of $20 billion to $30 billion a year.[29]

Thus, recent actions by the Federal Reserve to address the turmoil in the markets may affect federal revenues through their impact on the amount of earnings that the central bank remits to the Treasury. Those earnings will be diminished by any losses that resulted from creditors being unable to repay loans or from assets that the Federal Reserve acquired proving to be worth less than the cost to acquire them. The central bank has committed nearly $2.3 trillion to its programs, but the assets purchased through those programs are backed by collateral. Still, CBO estimates that the Federal Reserve will incur modest losses, although it is expected to eventually recoup nearly all of its investments. Nevertheless, losses are possible; for example, the Federal Reserve has already written down—by about $2 billion—the value of the assets it acquired in the takeover of Bear Stearns.

The Troubled Asset Relief Program. CBO records spending for the TARP on a risk-adjusted discounted-present-value basis rather than on a cash basis.[30] That is, CBO accounts for the costs resulting from interest subsidies, potential defaults on lending, and other factors. As is the case with the Federal Reserve's transactions, the principal of most of the assets acquired under the TARP should be repaid over time. Of the $700 billion that the TARP is expected to disburse before the end of December of this year, CBO anticipates that the subsidy cost (after adjusting for market risk) will be about $200 billion.

Purchases of Mortgage-Backed Securities. The Treasury is also purchasing mortgage-backed securities in the private market. Again, those transactions are basically an exchange of assets—the Treasury has used cash to buy the securities and will receive cash upon the sale of the asset or at its maturity. Because there is no statutory provision for an alternate treatment, the cost of purchases of mortgage-backed securities is computed using standard credit reform procedures.[31] To date, the net cost of those purchases is close to zero.

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29. The Federal Reserve is now paying interest on required reserves and excess balances held on behalf of financial institutions. The interest rate paid on those deposits is currently set at 0.25 percent; CBO estimates that the Federal Reserve will incur interest costs of less than $5 billion in 2009. Authorization to pay interest on such reserves came from the Emergency Economic Stabilization Act of 2008, which advanced the effective date of a provision of the Financial Services Regulatory Relief Act of 2006 that was slated to take effect in 2011.

30. The Administration is accounting for capital purchases made under the TARP on a cash basis rather than the present-value basis adjusted for market risk that was specified in the Emergency Economic Stabilization Act of 2008. (Present value is the value on a given date of a future payment or series of future payments, discounted using an appropriate interest rate to reflect the risk and term to maturity of the underlying asset.) The Administration's treatment will show more outlays than will CBO's treatment for the TARP this year and then will show cash receipts in future years.

31. For an explanation of credit reform, see Congressional Budget Office, *Policy Options for the Housing and Financial Markets*, Box 3-2 (April 2008).

Fannie Mae and Freddie Mac. In CBO's baseline projections of the federal budget, most of the cost recorded in 2009 for Fannie Mae and Freddie Mac stems from the existing assets and liabilities of the two GSEs at the time of their takeover. CBO estimates that the value of the GSEs' mortgage loans and guaranteed assets falls short of their liabilities by about $200 billion (on a present-value basis); that amount is included in CBO's estimate of the deficit as calculated for 2009. Nearly $40 billion in 2009 and smaller annual amounts thereafter represent the estimated annual subsidy costs (on a net-present-value basis) associated with the GSEs' new business after the takeover. The decline in the annual subsidy reflects CBO's forecast that the housing and mortgage markets will stabilize over the next several years.

CBO has long held that the federal government has subsidized the operation of Fannie Mae and Freddie Mac by providing what some have called an "implicit guarantee" of the GSEs' debt.[32] However, the federal government has never recognized the cost of the subsidy in its budget. The value of that guarantee (the existence of which has now been demonstrated by the Treasury) is a large component of the estimated cost of the GSEs' operations that CBO has included in its baseline budget projections.

Other Agencies. A few other agencies have also taken actions in response to the turmoil in the markets, either through existing authority or on the basis of recent legislation. The FDIC has temporarily raised the limit on insurance coverage—from $100,000 to $250,000 per depositor—and has established a program to enhance liquidity by guaranteeing debt issued by banks as well as deposits in checking accounts and other non-interest-bearing accounts. The FDIC will also provide assistance to Citigroup in conjunction with the TARP and the Federal Reserve.

Financial turmoil has also affected credit unions. As a result, the National Credit Union Administration, or NCUA (the federal agency that charters and supervises federal credit unions and insures deposits) has created programs to ensure the liquidity of its member institutions. The costs incurred by the FDIC and NCUA are treated in the budget on a cash basis.

The Department of Housing and Urban Development (HUD) has established several programs in an attempt to reduce foreclosures and address other issues in the housing market. Many of those programs were created by the Housing and Economic Recovery Act of 2008, but HUD has also used existing authority to create the FHA Secure program. HUD's programs are also treated in the budget on a cash basis.

Differences Between CBO and the Administration in the Treatment of Policy Actions in the Budget

By this point, two major differences have arisen between CBO and the Administration in their treatment of policy actions taken in response to the financial crisis. One

32. See Congressional Budget Office, *Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac* (May 1996), and *Federal Subsidies and the Housing GSEs* (May 2001).

involves the recording of the budgetary costs of the TARP, and the other deals with the costs related to the conservatorship of Fannie Mae and Freddie Mac.

The Troubled Asset Relief Program. Section 123 of the Emergency Economic Stabilization Act of 2008 states that the federal budget should display the costs of purchasing or insuring troubled assets by using procedures similar to those specified in the Federal Credit Reform Act but with an adjustment to account for market risk. Under that procedure, the federal budget would not record the gross cash disbursement for the purchase of a troubled asset (or the cash receipt for its eventual sale) but instead would reflect the market value of the asset or an estimate of the government's net cost (on a present-value basis) for the purchase. Broadly speaking, the net cost is the purchase cost minus the present value—calculated using an appropriate discount factor that reflects the riskiness of the underlying cash flows associated with the asset—of any estimated future earnings from holding the asset and the proceeds from its eventual sale.

Following that directive, CBO has estimated that the net costs of the TARP's activities through January 22, 2009 (with $293 billion disbursed), total $94 billion. That calculation implies a subsidy rate of 32 percent—that is, the net subsidy (in 2009 dollars) amounts to an estimated 32 percent of the government's initial expenditures. CBO and the Administration's Office of Management and Budget do not differ significantly in their assessments of the subsidy cost of those transactions but vary in their judgment as to how the transactions should be reported for budgetary purposes.

OMB submitted its first report to the Congress on the costs of the Treasury's purchases and guarantees of troubled assets on December 5, 2008;[33] at the time that the report was compiled (November 6, 2008), the TARP had disbursed $115 billion to eight large banks in exchange for preferred stock and warrants (securities that entitle the holder to buy stock of the company that issued them at a specified price). OMB maintains that the Federal Credit Reform Act applies only to direct loans and loan guarantees and that the reference in the Emergency Economic Stabilization Act does not require the use of credit reform procedures for other types of transactions. As a result, it budgeted for those initial TARP disbursements on a cash basis rather than by reporting the estimated subsidy cost.

In its December report on the TARP, however, OMB also provided two alternative estimates of the subsidy cost of that first set of disbursements. One such estimate was valued using procedures similar to those specified in the Federal Credit Reform Act (discounting future cash flows using a risk-free rate), and the other estimate was calculated using an approach similar to the way CBO treats the TARP (discounting future cash flows while adjusting for estimated market risk). OMB's second alternative calculation is comparable to CBO's assessment of the cost of the first $115 billion of trans-

33. Office of Management and Budget, "OMB Report Under the Emergency Economic Stabilization Act, Section 202," letter to the Honorable Nancy Pelosi (December 5, 2008), available at www.whitehouse.gov/omb/legislative/eesa_120508.pdf.

actions. Using a modified credit reform basis (that is, adjusting for risk), OMB estimated those costs to be $25.5 billion, or a subsidy rate of 22 percent, and CBO arrived at a cost of $20.5 billion, or a subsidy rate of 18 percent. Most of that difference is probably explained by such factors as the discount rate used (which is affected by when the estimates were made) and the volatility of stock prices (which affects the potential value of the warrants).

Fannie Mae and Freddie Mac. CBO has concluded that because of the extraordinary degree of management and financial control that the government has exercised, Fannie Mae and Freddie Mac should now be considered federal operations. Although the GSEs are not legally government agencies and their employees are not civil servants, CBO believes it is appropriate and useful to policymakers to account for and display the GSEs' financial transactions alongside all other federal activities in the budget.

However, the Administration continues to treat the two organizations as separate from the government. As a result, it has so far recorded the cash infusion that the Treasury provided to Freddie Mac ($13.4 billion) as an outlay. By contrast, CBO considers such payments as intragovernmental transfers that have no net effect on the budget.

Table 1.

Actions Taken by the Federal Reserve in Support of the Housing and Financial Markets as of January 22, 2009

(Billions of dollars)

Action	Funding: Committed to Date	Funding: Potential[a]	Description
Reductions in Interest Rates	n.a.	n.a.	The target for the federal funds rate (the interest banks charge on loans to other banks) was reduced 10 times between September 2007 and December 2008, falling from 5.25 percent to between zero and 0.25 percent.
Loans to Financial Institutions			
Primary and Secondary Credit Programs	63	Unknown	Through the primary and secondary credit programs, the Federal Reserve disburses short-term loans to banks and other institutions that are legally allowed to accept monetary deposits from consumers. The term of the loan may be as long as 90 days.
Term Auction Facility	416	600	The Term Auction Facility (TAF) allows banks and other financial institutions to pledge collateral in exchange for a loan from the Federal Reserve. The interest rate on the loan is determined by auction; such auctions are conducted biweekly for loans with a maturity of either 28 or 84 days. The maximum size of each auction is $150 billion, although accepted bids for most recent auctions have been considerably smaller.
Takeover of Bear Stearns Backed assets to facilitate takeover of Bear Stearns by JP Morgan Chase	29	29	The Federal Reserve created Maiden Lane I, a limited liability company (LLC), to acquire certain assets of Bear Stearns at a cost of $29 billion. (An LLC offers protection from personal liability for business debts, just like a corporation. The profits and losses of the business pass through to its owners, as they would if the business was a partnership or sole proprietorship.) The LLC will manage those assets to maximize the likelihood that the investment is repaid and to minimize disruption to financial markets. The current value of the portfolio on the Federal Reserve's balance sheet is $27 billion.

Continued

Table 1. Continued

Actions Taken by the Federal Reserve in Support of the Housing and Financial Markets as of January 12, 2009

(Billions of dollars)

Action	Funding: Committed to Date	Funding: Potential[a]	Description
Support for AIG Acquired control of nearly 80 percent of the insurance company	82	113	The Federal Reserve agreed to loan AIG $60 billion and acquired control of nearly 80 percent of the company. In addition, the Federal Reserve Bank of New York bought $19.5 billion of residential mortgage-backed securities from AIG's portfolio through an LLC and another $24.5 billion of collateralized debt obligations (CDOs) on which AIG wrote contracts for credit default swaps through another LLC. (CDOs are complex financial instruments that repackage assets such as mortgage bonds, loans for leveraged buyouts, and other debt—including other CDOs—into new securities. A credit default swap is a type of insurance arrangement in which the buyer pays a premium at periodic intervals in exchange for a contingent payment in the event that a third party defaults. The size of the premium paid relative to the contingent payment generally increases with the likelihood of default.)
Support for Short-Term Corporate Borrowing Commercial Paper Funding Facility	351	1,800	The Commercial Paper Funding Facility (CPFF) finances the purchase of commercial paper (securities sold by large banks and corporations to obtain funding to meet short-term borrowing needs, such as payroll) directly from eligible issuers. Securities purchased under this program may be backed by assets or unsecured; they must be highly rated, denominated in U.S. dollars, and have a maturity of three months. The program is in effect through April 30, 2009.
Support for Money Market Mutual Funds			
Money Market Investor Funding Facility	0	540	The Money Market Investor Funding Facility (MMIFF) is designed to restore liquidity to money markets by purchasing certificates of deposit, bank notes, and commercial paper from money market mutual funds and other similar investors. The authority to purchase assets is in effect through April 30, 2009.

Continued

Table 1. Continued

Actions Taken by the Federal Reserve in Support of the Housing and Financial Markets as of January 22, 2009

(Billions of dollars)

Action	Funding: Committed to Date	Funding: Potential[a]	Description
Support for Money Market Mutual Funds (Continued)			
Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility	15	Unknown	The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) provides funding to U.S. depository institutions and bank holding companies to finance their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds under certain conditions. The program is intended to assist money market funds that hold such paper in meeting demands for redemptions by investors and to foster liquidity in the ABCP market specifically and money markets generally. The program is in effect through April 30, 2009.
Support for Primary Dealers			
Term Securities Lending Facility and TSLF Options Program	133	200	The Term Securities Lending Facility (TSLF) offers to lend Treasury securities held by the Federal Reserve for a one-month term in exchange for other types of securities held by the 17 financial institutions, known as primary dealers, that trade directly with the Federal Reserve. The TSLF Options Program (TOP) offers options on short-term TSLF loans that will be made on a future date. (An option is a contract written by a seller that conveys to the buyer the right—but not the obligation—to buy or sell a particular asset.)
Primary Dealer Credit Facility	33	Unknown	The Primary Dealer Credit Facility (PDCF) provides overnight loans in exchange for eligible collateral to financial institutions that trade directly with the Federal Reserve. The program is in effect through April 30, 2009.
Support for the Mortgage Market			
Purchases of the debt of the housing-related government-sponsored enterprises	23	100	The Federal Reserve will purchase up to $100 billion in debt issued by three government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—through competitive auctions over the next several quarters.

Continued

Table 1. Continued

Actions Taken by the Federal Reserve in Support of the Housing and Financial Markets as of January 22, 2009

(Billions of dollars)

Action	Funding: Committed to Date	Funding: Potential[a]	Description
Support for the Mortgage Market (Continued)			
Purchases of mortgage-backed securities	53	500	Over the next several quarters, the Federal Reserve will purchase up to $500 billion in mortgage-backed securities (MBSs) issued by GSEs and the Government National Mortgage Association (Ginnie Mae).
Support for Consumer and Small Business Lending Term Asset-Backed Securities Loan Facility	0	200	Through the Term Asset-Backed Securities Loan Facility (TALF), the Federal Reserve Bank of New York will lend up to $200 billion to holders of certain AAA-rated asset-backed securities (consumer and small business loans), and the Troubled Asset Relief Program will provide $20 billion of credit protection (protection against debtors that do not pay because of insolvency or protracted default) for those loans. The TALF is expected to begin lending in February 2009; the authority expires on December 31, 2009.
Assistance to Citigroup	0	234	The Federal Reserve will absorb 90 percent of any losses resulting from the federal government's guarantee of a pool of Citigroup's assets after payouts have been made by Citigroup, the Troubled Asset Relief Program, and the Federal Deposit Insurance Corporation.
Assistance to Bank of America	0	87	The Federal Reserve will absorb 90 percent of any losses resulting from the federal government's guarantee of a pool of Bank of America's assets after payouts have been made by Bank of America, the Troubled Asset Relief Program, and the Federal Deposit Insurance Corporation.
Currency Swaps	At least 500	Unlimited	In response to strong demand for dollars from abroad, the Federal Reserve has contracted with 14 foreign central banks to make U.S. dollars available temporarily. After a specified period of time, the original amounts of dollars will be returned in exchange for the foreign currency.

Source: Congressional Budget Office based on information from the Federal Reserve.

Note: n.a. = not applicable.

a. "Potential funding" refers to the size of the market or the maximum amount of lending under the program.

Table 2.

Actions Taken by the Treasury in Support of the Housing and Financial Markets as of January 22, 2009

(Billions of dollars)

Action	Disbursements To Date	Disbursements Potential[a]	Subsidy[b] (Credit basis)	Description
Troubled Asset Relief Program	293	700	94	The Emergency Economic Stabilization Act of 2008 (Division A of P.L. 110-343) granted authority to the Treasury to purchase $700 billion in assets through a new program, the Troubled Asset Relief Program (TARP). The second $350 billion will become available on January 27, 2009. As of January 22, the program had disbursed $293 billion. The subsidy cost estimated by the Congressional Budget Office—about $94 billion to date—is computed using the modified credit reform procedure (that is, accounting for market risk) specified in P.L. 110-343.
Housing-Related Tax Provisions	0	12	n.a.	The Housing and Economic Recovery Act of 2008 (P.L. 110-289) authorized a refundable tax credit for first-time home buyers (to be repaid, without interest, over a 15-year period) and contained other housing-related tax provisions.
Purchases of Obligations and Securities Issued by Fannie Mae and Freddie Mac	71	Unlimited	-1	The Housing and Economic Recovery Act of 2008 authorized the Department of the Treasury to buy obligations and securities issued by Fannie Mae and Freddie Mac. About $71 billion of residential mortgage-backed securities (securities whose value is derived from an underlying pool of mortgages) had been purchased as of December 31, 2008. Authority to make such market purchases expires on December 31, 2009. The subsidy cost recorded in the budget is computed using standard credit reform procedures.

Continued

Table 2. Continued

Actions Taken by the Treasury in Support of the Housing and Financial Markets as of January 22, 2009

(Billions of dollars)

Action	Disbursements To Date	Disbursements Potential[a]	Subsidy[b] (Credit basis)	Description
Conservatorship for Fannie Mae and Freddie Mac	14	200	n.a.	The Treasury received senior preferred equity shares and warrants in exchange for any future contributions necessary to keep the two entities solvent. (Preferred equity shares provide a specific dividend to be paid before any dividends are paid to common stockholders and take precedence over common stock in the event of a liquidation; a warrant is a security that entitles the holder to buy stock of the company that issued it at a specified price.)
Temporary Guarantee Program for Money Market Funds	Unknown	3,000	n.a.	The Treasury will guarantee investors' shares as of September 19, 2008. The guarantee is in effect through April 30, 2009, but can be extended through September 18, 2009. Participating funds pay a fee of 1.5 or 2.2 basis points times the number of shares outstanding. (A basis point is one-hundredth of a percentage point.)
Supplementary Financing Program	175	Unlimited	n.a.	The Treasury is borrowing from the public to assist the Federal Reserve.

Source: Congressional Budget Office based on information from the Department of the Treasury.

Note: n.a. = not applicable.

a. "Potential disbursements" refers to the maximum amount of spending under the program or the maximum amount of outstanding assets available for guarantee.

b. "Subsidy," broadly speaking, refers to the purchase cost minus the present value of any estimated future earnings from holding those assets and the proceeds from the eventual sale of them.

Table 3.

Actions Taken by Other Agencies in Support of the Housing and Financial Markets as of January 22, 2009

(Billions of dollars)

Action	Disbursements To Date	Disbursements Potential[a]	Description
		Federal Deposit Insurance Corporation	
Temporarily Raised the Basic Limit on Insurance Coverage from $100,000 to $250,000 per Depositor	n.a.	700	The Emergency Economic Stabilization Act of 2008 (Division A of P.L. 110-343) temporarily raised the limit on deposit insurance through December 31, 2009. That action is estimated to increase the amount of insured deposits by about $700 billion, or 15 percent.
Temporary Liquidity Guarantee Program	n.a.	1,450	The Temporary Liquidity Guarantee Program has two components. The first—the debt guarantee program—aims to enable participating institutions to borrow and lend money more readily. It fully protects certain newly issued senior unsecured debt (securities that are not backed by collateral and have priority over all other debt in ranking for payment in the event of default) with a maturity of more than 30 days, including promissory notes, commercial paper (securities sold by large banks and corporations to meet short-term needs, such as payroll), and interbank funding. The guarantee applies to debt that is issued by June 30, 2009, and matures no later than June 30, 2012. Participating institutions pay fees based on the maturity of the debt. To date, the Federal Deposit Insurance Corporation (FDIC) has guaranteed $238 billion of new debt; potential guarantees could total $1 trillion. The second component provides full guarantees for certain checking and other non-interest-bearing accounts through December 31, 2009. Participating institutions also pay fees for this guarantee, which could total $450 billion.

Continued

Table 3. Continued

Actions Taken by Other Agencies in Support of the Housing and Financial Markets as of January 22, 2009

(Billions of dollars)

Action	Disbursements To Date	Disbursements Potential[a]	Description
Federal Deposit Insurance Corporation (Continued)			
Assistance to Citigroup	0	10	The FDIC may absorb up to $10 billion in losses resulting from the federal government's guarantee of a pool of Citigroup's assets after payouts have been made by Citigroup and the Troubled Asset Relief Program. As a fee for the guarantee, the FDIC will receive $3 billion in preferred stock (shares of equity that provide a specific dividend to be paid before any dividends are paid to common stockholders and that take precedence over common stock in the event of a liquidation).
Department of Housing and Urban Development			
Redevelopment of Abandoned and Foreclosed Homes	0	4	The Housing and Economic Recovery Act of 2008 (P.L. 110-289) provided $4 billion in funding to state and local governments to purchase and rehabilitate foreclosed and abandoned homes.
HOPE for Homeowners Program	0	1	The HOPE for Homeowners program permits home mortgages to be refinanced through private lenders with a guarantee from the Federal Housing Administration. The new loans must have a loan-to-value ratio that is no greater than 90 percent of the property's appraised value.
FHA Secure	n.a.	1	FHA Secure was a temporary initiative to permit lenders to refinance non-FHA (Federal Housing Administration) adjustable-rate mortgages. The program has made about 4,000 loans since fall 2007 and expired on December 31, 2008.
Federal Housing Finance Agency			
Conservatorship for Fannie Mae and Freddie Mac	n.a.	n.a.	The Federal Housing Finance Agency and the Treasury took control of these two government-sponsored enterprises (GSEs) on September 6, 2008. Under the current circumstances, the Congressional Budget Office (CBO) views Fannie Mae and Freddie Mac as governmental entities.

Continued

Table 3. Continued

Actions Taken by Other Agencies in Support of the Housing and Financial Markets as of January 22, 2009

(Billions of dollars)

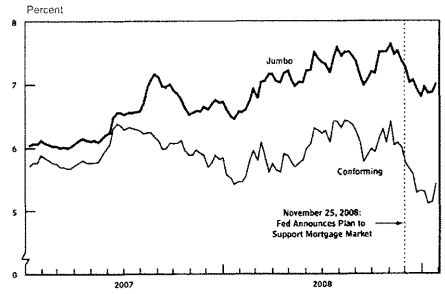
	National Credit Union Administration		
Streamlined Modification Program	Unknown	Unknown	The Streamlined Modification Program is intended to avoid foreclosures by creating a fast-track method for reducing monthly payments on mortgages. The program will restrict payments to 38 percent of a household's gross monthly income by reducing the interest rate, extending the life of the loan, or deferring principal. That policy applies to loans held by Fannie Mae and Freddie Mac and was launched on December 15, 2008.
Credit Union Homeowners Affordability Relief Program and Credit Union System Investment Program	5	41	These two loan programs are operated through the National Credit Union Administration's Central Liquidity Facility and are financed by borrowing from the Federal Financing Bank. The Credit Union Homeowners Affordability Relief Program (CU HARP) will provide subsidized funding intended to help credit unions modify mortgages. The Credit Union System Investment Program (CU SIP) seeks to facilitate lending by shoring up corporate credit unions (which primarily provide financial resources and services to other credit unions).
Temporary Corporate Credit Union Liquidity Guarantee Program	n.a.	Unknown	The Temporary Corporate Credit Union Liquidity Guarantee Program guarantees certain unsecured debt of participating corporate credit unions that was or will be issued between October 16, 2008, and June 30, 2009. Such debt must mature by June 30, 2012. Participating institutions pay annualized fees for the guarantees. To date, this program has guaranteed $5 billion in debt.

Source: Congressional Budget Office based on information from the Federal Deposit Insurance Corporation, the Department of Housing and Urban Development, the Federal Housing Finance Agency, and the National Credit Union Administration.

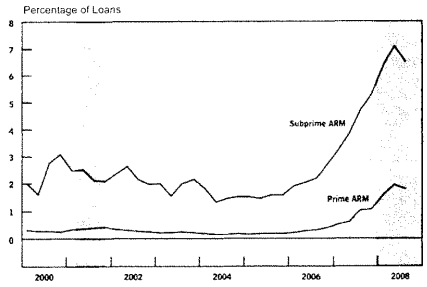
Note: n.a. = not applicable.

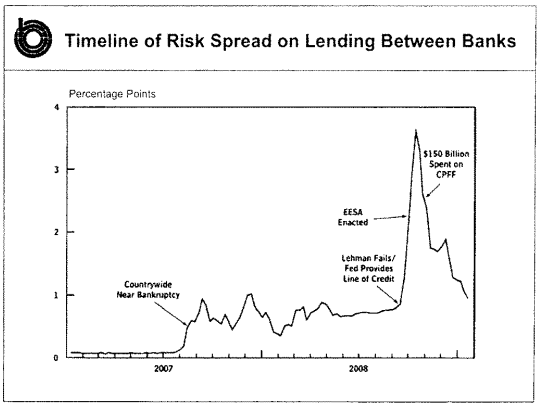
a. "Potential disbursements" refers to the maximum amount of spending under the program or the maximum amount of outstanding assets available for guarantee.

Interest Rates on Mortgage Loans, January 2007 to January 2009



Foreclosure Rates, 2000 to 2008





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Chairman CONRAD. Thank you very much for your excellent testimony, Dr. Elmendorf, and, again, thank you for your service.

Let me turn very directly to some of the possibilities you mentioned with respect to dealing with the housing crisis and the continuing troubles in the financial sector. When the Farm Credit System faced a crisis in the 1980's, we were told the Farm Credit System was insolvent, that unless we acted, the whole system would come down. And I remember at that time the advice I had received from Carl Pohlad, who was the owner of the Minnesota Twins—but

that did not have anything to do with his expertise in banking. He was also probably the largest private banker in our region of the country, headquartered in Minneapolis.

Carl Pohlad asked me to his office when we were going through the S&L bailout consideration, and he had a stack of financial reports up the wall of his office. He had done more due diligence on S&Ls than probably any other person. And he said, "Kent, whatever you do, don't take these properties into Government hands." He said, "Inject money into the institutions, require them to rework the bad loans, and have them do the workouts. They know a lot more about these loans than any Government agency will. Government can do a lot of things. It does not manage property well." And so he said, "Whatever you do, don't take title, don't take these properties into Government hands."

And, unfortunately, we went a different direction with the S&Ls. I was one of a handful that voted against it on that basis. Then in the farm credit crisis, we followed that advice. We did not take title. We injected capital into the system, and we insisted that they rework the existing loans, and ultimately it did not cost the taxpayers a dime. In fact, we made a little bit of money—a very little bit, but a little bit. And I am wondering if those same principles do not apply here.

Now, maybe you can help me understand. Why wouldn't it be better—if we form a bad bank, we are going to take ownership of those assets. If instead we provide guarantees and then insist on them doing the workouts—they have got the network across the country to do them. They know more about what is in those loan portfolios than we are ever going to know. Why shouldn't those principles guide us in this circumstance?

Mr. ELMENDORF. I think, Mr. Chairman, that nearly all analysts would agree that for the Government to be trying to specifically run banks on a day-to-day basis to manage those assets would not be the most efficient approach. So having a guarantee is one way, as you say, to keep those assets in the hands of the banks.

I think if we set up, if the Government were to help set up, to subsidize the creation of good banks and bad banks, that does not mean necessarily the Government would directly run the bad banks. When the Federal Reserve took over part of the portfolio of Bear Stearns last spring, they own it, but as far as I understand, all the decisions involving it are made by one private management firm with which the Federal Reserve Bank of New York has contracted to run that portfolio. So it is at least an arm's-length transaction in which economists or analysts at the Federal Reserve Bank of New York are not making specific decisions about how to manage individual assets. Not to say that a good bank/bad bank is necessarily better. I understand that there are ways to keep that a little bit removed.

I think with a guarantee, one thing, of course, to be very careful about is that that has costs to the Government as well, and as you and your colleagues make these kinds of decisions, you need to recognize—and CBO will try to provide estimates of the cost—the guarantees are costly, certainly in a risk-adjusted sense. It is not obvious whether the Government will lose money or how much, but the expectation of that, given the risks, is a real cost that should

be recognized, as it has been in our budgeting regarding the TARP and the decision to put Fannie Mae and Freddie Mac into conservatorship and so on.

Chairman CONRAD. Let me just stop you on that point, because I absolutely recognize that guarantees cost money. And I am not one who has ever believed that we are going to make money on these deals. I did not believe it at the beginning. I do not believe it now. But my experience with guarantees has been they cost less than us taking over the asset and trying to manage it. And, you know, that is just the experience that I have had, and that guarantees, if there is recovery or when there is recovery—all of us believe there will be recovery at some point—you know, you will get a bounce-back in those asset values and that those guarantees that are put in place, partly to restore confidence, will wind up costing you a fraction of what the nominal value is.

Mr. ELMENDORF. I think the confidence point is extremely important. We need to find a way to get private capital flowing back into the financial system. The Government does not want to be responsible for providing all the resources or making all the decisions, and private capital is important both for the funds involved and because it gives the private sector some of the decisionmaking about which firms are viable, which firms are following successful long-term strategies. But I think the confidence is important.

One virtue that some analysts see in a good bank/bad bank approach is that it firmly separates the problems from the past from new loans going forward. And I think a risk of guarantees is that they would not be sufficient—the separation would not be sufficiently clear, and that would hinder banks' raising new capital and focusing their energies on their future business. And I think that would be an important aspect of pursuing a guarantee strategy, is to make it sufficiently clear what the remaining banks' risks are as a way of drawing in other capital.

I would also just add quickly that the experience of our country in larger crises like the S&L—not larger than this one, but fairly large up until now—like the S&L crisis, or other countries with very large financial crises, like Japan or Sweden, they end up being expensive for the Government. There are very few examples of important financial crises that are enduredwithout governments ending up spending a good deal of money.

Chairman CONRAD. Well, I must say I was directly involved in the farm credit crisis, and one thing I would like is to have you go back and have your people take a look at that, because it worked and it did not cost taxpayers money. And we faced the insolvency of the entire Farm Credit System at the time.

Very quickly on another matter, because my time is just about out, the housing crisis to me screams out for more aggressive steps, including an expanded credit for people buying homes. As you know, we have in the House package $7,500. It does not have to be repaid, but it applies only to first-time homebuyers.

In your analysis, does a credit of that type affect behavior?

Mr. ELMENDORF. Oh, yes. I think that a credit that reduces the cost of buying a home will lead to more homes being purchased. I do not know offhand how important quantitatively we think that sort of credit would be.

I think it would be very difficult to reverse the slide in house prices overnight. As you know, we have a tremendous glut of unsold homes. We are entering worse economic conditions in this year than we had even last year. So I think we should not think that we can turn that on a dime. Efforts to support housing demand, those certainly help.

And I think the other consideration there, of course, is the duration of this additional support for the housing sector. We have as a country provided a number of important supports for housing demand through the tax deduction of mortgage interest, through Fannie Mae and Freddie Mac and a variety of features of the financial system. I think it is a fair question about how much public policy we want to be focused on increasing housing demand over the long term. But certainly in the short term, more housing demand would help to turn house prices back up sooner than otherwise and help to turn housing construction back up sooner than otherwise.

Chairman CONRAD. This credit would only be through August of this year.

Senator Gregg.

Senator GREGG. Dr. Elmendorf, shouldn't any stimulus package not add to the long-term baseline? Shouldn't it be basically focused on the immediate problem, be temporary, be targeted, and have a horizon which is definable rather than be a baseline builder in the out-years, 5, 10, 15 years from now?

Mr. ELMENDORF. Yes. CBO has enunciated several criteria for effective fiscal stimulus, that the stimulus be timely, that it occur during a period of economic weakness.

I want to emphasize here that as CBO looks out into the future and as most economists look out to the future, we see the period of economic weakness persisting for some time. We are looking for a shortfall in output relative to potential output of a trillion dollars this year and next year, and more than half of that in 2011. So the period of weakness we think will be quite long, but not 5 years or 10 years.

We also talk about specific criteria about cost-effective and about not worsening the long-run fiscal imbalance.

Senator GREGG. Now, you mentioned about five different approaches to fixing the housing industry, and you talked about the pluses and minuses of each one and came to the conclusion that none of them were perfect. And that you might want to try a variety of them and a mixture of them, potentially.

But as I look at the stimulus package as it has come to us, virtually none of them are tried even though on the stimulus package we are spending almost a trillion dollars. And the number that I heard—I do not know this to be accurate—is that we have got about a trillion dollars of assets that are not performing and that that is what we need to work through the system, essentially.

So wouldn't it make more sense to take this stimulus package and refocus it or at least focus a larger percentage of it on the issue of housing if we want to get to the underlying problem that is driving the economic slowdown?

Mr. ELMENDORF. I think most economists would say that all of the above are needed, that both fiscal stimulus to spur demand and targeted housing and financial policies are appropriate.

You are right, this stimulus package, as it has been considered in the House and the Senate, addresses the broader goal of boosting demand for goods and services in the economy. It does not do very much—the Chairman mentioned some pieces, but it does not do very much to arrest the housing and financial problems. I do not think that is the case of people not understanding the need for other policies, but simply doing one piece at a time. But that is a matter of legislative strategy that I am not an expert on.

Senator GREGG. Well, of course, we only have so much debt that we can issue. At some time people are going to start saying we have issued too much debt, and if we are going to use a trillion dollars on this stimulus package, I think it would be helpful if we used a fair amount of that trillion to address the housing industry, which is what I see to be the core problem.

Another proposal that is out there to stimulate the housing industry that I find attractive is to develop a national program, which could probably be run through Fannie Mae and Freddie Mac, where we would essentially create a mortgage rate of 4 percent. For a period of a year and a half or 2 years, you could get a mortgage, a 4-percent 30-year mortgage, which would essentially be subsidized by a percentage point from the Federal Government.

Have you looked at that as a way of stimulating the housing industry? And if you have, do you think it would?

Mr. ELMENDORF. CBO is in the process of studying some particular version of that proposal. We have not completed the analysis. I think it would certainly stimulate housing demand. As I said to Chairman Conrad, anything which brings down the cost of buying a house is going to lead to more demand for housing, and that would have salutary macroeconomic effects at the moment.

I think the considerations that we will discuss when we report officially on this proposed legislation are, No. 1, it would be costly for the Government. Private mortgage rates are currently about 5.5 percent. If the Government issues mortgages essentially at 4 percent, that is a one-and-a-half-percentage-point subsidy, essentially. And the cost of that should be recognized, of course.

Senator GREGG. Well, it would be a cost, but as a practical matter, if you opened the window for, say, a year and a half to clear out inventory, I think in the long run the benefit to the economy would overwhelm the cost because you would start to stabilize housing prices, which is at the essence, in my opinion, of our problem.

Another point that you made that I want to follow up on is thatyou said we need to find a way to get private capital into the banking system. That is absolutely essential, in my opinion. So as we address the fixing of this problem, we should not do anything that essentially chills the future willingness of the private markets to come in and replace the Federal Government;s current investment in the banking system.

Mr. ELMENDORF. Right.

Senator GREGG. We want the private market to come in and essentially start taking the equity positions, start lending money, and bringing capital into the system rather than have the Federal Government or the Fed Reserve be the supplier of capital. Correct?

Mr. ELMENDORF. Yes, I think absolutely.

Senator GREGG. Now, so when you have people—for example, unfortunately, the Speaker of the House and an economist from Columbia, my alma mater, where some people are a little misdirected on some issues of fiscal policy—who suggest that we should nationalize major institutions in the financial area, such as Sweden did and such as it appears England may do with the Royal Bank of Scotland, my view is that that is an extraordinarily counterproductive statement to make in this market and will have a massively chilling effect on the willingness of private capital to participate. We are a capitalist system. We are obviously experiencing fairly significant distress, but we have at our core our great productivity, and our great strength is that people take risks and invest. And language about nationalization undermines that atmosphere, doesn't it?

Mr. ELMENDORF. I think concern about the future actions the Government might take or not take is an important factor in holding back private capital from entering the banking system now. And one of the virtues of trying to lay out a strategy, a clear plan for how to proceed is that it alleviates that uncertainty.

Senator GREGG. So I would hope people would be more tempered in their responses, even if they are economists at academic institutions.

Thank you.

Mr. ELMENDORF. Thank you.

Chairman CONRAD. Thank you, Senator Gregg.

Senator Merkley? I would just say to the new Senators that we operate on an early bird rule in this Committee. So Senators who are here first get first recognition, even if they start at the end of the table, which is exactly where I started, Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chairman. It is a delight to be here. I had an opportunity to work for the Congressional Budget Office for a number of years, preparing briefings for Congress, and I am delighted to be reading similarly well-prepared work here now years later.

Mr. ELMENDORF. Thank you, Senator. The quality of this work is a credit to the people sitting here in the first row behind me.

Senator MERKLEY. Great. I keep telling my staff: "On that question, call up the CBO analyst who is working on it. We will get some good information." I hope I do not overload them with requests.

Are you familiar with the details of the FDR strategy when we were in a similar challenge with the dropping value of houses and mortgages underwater?

Mr. ELMENDORF. I know a certain amount about the Home Owners' Loan Corporation—is that what you are referring to?—that bought up a large amount of outstanding mortgages and then refinanced them.

Senator MERKLEY. Yes. Are there insights there as we face this challenge?

Mr. ELMENDORF. I think there are. The situation, of course, was quite different. Although our current outlook is as bleak as it has been in this country since the Depression, it is not at all comparable to what it was in the mid-1930's when HOLC was doing its business. I believe the delinquency rate on mortgages at the

time was pushing 50 percent as opposed, perhaps, to the 10 percent that we see today.

But I think it is instructive in terms of magnitude of the effort that a lot of mortgages were bought, a lot were refinanced, and that many different aspects of policy were at work, of course, at that time, but the HOLC seems to have been part of what turned the housing market and the economy back up again.

I think the thing one should be careful about is that the HOLC seems not to have lost the Government money on a cash basis, and that would be a desirable outcome of interventions we might consider now, but I think would not be the best estimate of the outcome of policies we might pursue now.

Senator MERKLEY. Thank you. The general parallel, as I understand it, is that we had mortgages that had two problems: one is they were callable, and the second is that they were often 10-year balloons, and by reissuing 30-year mortgages, it stabilized families and stabilized the economy and stabilized the downward pressure on houses. I am interested in learning a little bit more about some of the other details, how they dealt with the underwater mortgages and so forth for insights.

In your presentation, at least in the written portion, you go into a lot of the details about the challenges of getting current lenders to renegotiate. The owner of the loan has sold the cash-flows. The owners of the various cash-flows might sue. You can perhaps provide immunity, but you might create constitutional property problems.

It just seems to me like it is such a complicated direction, in terms of moving quickly to address the millions of mortgages that are challenged, that we cannot move fast enough and figure it out and that it is probably a sand pit.

Do you see any hope for going that direction and really being able to incentivize lenders? Or is it pretty much it is just too many complexities?

Mr. ELMENDORF. You are certainly right that speed is of the essence, and you are certainly right that the mortgage modification process is complicated in a way that works against our being able to do anything very quickly. That is a true challenge.

I think that more Government subsidy, however, will encourage more action, and yet more Government subsidy would encourage yet more action. I think the challenge that you and your colleagues face in making those choices is that it is also much more expensive the more subsidy one provides. And there is a tradeoff there, I think, between, on the one hand, the speed and number of people helped, but then against the budget cost of that.

Senator MERKLEY. As I have wrestled with this, I have wondered what is the—for those who own portfolios of mortgages—assuming those are marked down in their books to some fraction of the value, do we have a sense of what that is?

Mr. ELMENDORF. So far, world financial institutions have taken about a trillion dollars, have recognized officially about a trillion dollars of losses. Much of that is on mortgages or mortgage-related securities. I do not know the exact number offhand, but we can give you an estimate. And of that trillion dollars, about half has

been borne by U.S. institutions, which is the $500 billion that I referred to.

Looking ahead at prospective losses, analysts are looking for a fair amount of further mortgage losses, but also much more in loss on commercial real estate and on consumer loans, due partly because—importantly due to the weakening economic conditions and the effect of the recession.

Senator MERKLEY. I was thinking more in percentage terms, but let me just tell you the thought I was playing with. If a portfolio mortgage is marked down to 80 percent of its value, could you have a situation where the Government buys those mortgages at 80 percent, that they proceed to then guarantee private loans that refinance those mortgages, and so the Government essentially gets paid back every penny, and yet the family ends up stabilized with a fixed-rate, 30-year mortgage, and yet we do not experience, if you will, the massive sort of expenditure requirement that I know that many Members of the Senate are concerned about?

Mr. ELMENDORF. I think the problem here is that a pool of mortgages will be marked down in value based on some expectation of how many families will end up defaulting and what the losses on those defaults and foreclosures will be. But then when it comes to dealing with individual families, whoever controls the mortgage—private lenders now or the Government at some point—needs to decide whether to renegotiate that mortgage or not.

For a family that would otherwise go into foreclosure, modifying the mortgage to mark down the principal amount is going to be advantageous to the lender. On the other hand, for the families that will keep paying interest on their mortgage anyway, marking down the principal, and thus the mortgage payment, is disadvantageous to the lender.

So if the lenders could isolate the families that will end up defaulting, then renegotiating, modifying those mortgages would be useful. But if the only alternative is to modify all of the mortgages, all the ones that will go into foreclosure and all the ones that would not otherwise, then it gets very expensive per foreclosure. So as we noted, 10 percent of mortgages now—I think a little under 10 percent—are seriously delinquent or in foreclosure. Anything which is done for those 10 percent of the mortgage holders, which is very helpful to them, will look helpful to the other 50 or so million households.

That is a fundamental problem in this sort of modification, and it is a problem that private lenders face, and it is a problem the Government would face as well. And that is why it is hard to limit the losses that are realized, because you are in a sense helping other families that would like to be helped and might deserve to be helped, but would otherwise keep paying.

Senator MERKLEY. Well, and that is exactly the reason I was asking what the average percentage markdown is on the pool, which takes into account the entire extent of mortgages from those that are healthy to those that are not.

Another approach would be to basically buy out existing mortgages for those who are going under to have the new loan, the new first mortgage, be equal to the value of the house, to have the homeowner then also carry a silent second mortgage for the dif-

ference between the value of the first mortgage and, if you will, what they owed previously, perhaps with a shared appreciation model. In this case, the family still owes the same amount, but it is structured in such a fashion that they are much more likely to succeed and stabilize the family.

Is that an approach you all have worked through your models as to how that might be implemented?

Mr. ELMENDORF. I am not sure whether we have analyzed that particularly. I think how that changes the incentives of the families involved depends a lot on how the second mortgage is structured. So I understand your point about it being a shared appreciation mortgage.

I think those sorts of modifications certainly have potential, but we would need to work through the specifics. Obviously, in this sort of situation, the details matter a lot, and we would need to work that out specifically.

Senator MERKLEY. I will just close by saying I look forward to working with CBO, that I think that there are many challenges to figuring out a pathway to move quickly, that is fair to our taxpayers, and yet addresses the significant impact on failing mortgages on this downward cycle, and figuring out the right path will be critical not only to stabilizing millions of families, but to reversing the downward collapse of the economy.

Thank you very much.

Mr. ELMENDORF. Thank you, Senator.

Chairman CONRAD. Thank you, Senator.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman CONRAD. Can I just say, Senator Bunning, you know, I think you would be a $20 million man in today's baseball market.

Senator BUNNING. Well, since I cannot throw, it does not make any difference.

Welcome, Dr. Elmendorf.

Mr. ELMENDORF. Thank you.

Senator BUNNING. Thank you for being here.

Can I ask you about Fannie and Freddie specifically? At what point do bailed-out liabilities like Freddie and Fannie need to be brought—when do they need to be brought onto the Federal books of the Government? In other words, how should we treat the new taxpayer liability from recent investments in financial firms?

Mr. ELMENDORF. What CBO has done regarding Fannie and Freddie is to estimate the difference between the value of Fannie and Freddie's assets and liabilities at the time they were placed in conservatorship, and that differnece has been incorporated into our estimate of the budget deficit, and we put that—so we have already accounted for that. It is around $200 billion. And if our estimates turn out to be right, then there will be no further reckoning in the budget.

Of course, to the extent that we have underestimated or overestimated the amount of the difference, then we will make that adjustment down the road.

Senator BUNNING. Does that go with the same other different entities that—let us put it this way, rather than "bailout" since nobody likes to use those words around here—that we have invested,

the Federal Government has invested in like Citicorp, like AIG, like—I mean, we have equity. We have a piece of paper, but there is no assurance that that piece of paper is going to be worth anything, particularly I look at some of the continuing liabilities that seem to accumulate with bailed-out entities or reinvested entities. And instead of shrinking, they seem to be growing. We started at $85 billion at AIG, went to $150 billion, now we are at $200 billion. And the same thing happened at Citicorp. So I ask the same about that.

Mr. ELMENDORF. We have made the same sort of calculation for the moneys expended through the TARP program. We looked at the—as you know, the Government has taken preferred shares in a number of companies.

Senator BUNNING. Yes.

Mr. ELMENDORF. We have looked at the yields on the preferred shares of those companies trading in the private market as a private market measure of the risk involved, and we have used that risky interest rate, essentially, to discount the flows that we expect to get if all goes well. But, of course, the risk adjustment means that it might not go well, and it is out of that risk-adjusted present value calculation that we determined that for the entire—and looking ahead to what might be done with the rest of the TARP, but for the entire $700 billion that was authorized last fall, we estimate that the total cost of that to the Federal Government in this risk-adjusted present value sense is about $200 billion. That was also in our estimate of the budget deficit for this fiscal year.

So part of the reason why our estimate of this year's budget deficit was so high, $1.2 trillion, and higher than some analysts had predicted we would announce, is because of incorporating our estimate sort of a one-time basis of the expected costs for both Fannie Mae, Freddie Mac, and for the capital injections under the TARP.

Senator BUNNING. Let me switch gears on you just a little bit. Your predecessor, Peter Orszag, took a great deal of interest in the danger of unchecked entitlement spending. Do you share his views on this? If not, could you elaborate the differences?

Mr. ELMENDORF. I most absolutely share his views and I think all of our views about the dangers of the fiscal path the country is on. And we understand, I think all of us, that the rising cost of the health entitlements and of Social Security have put the Government budget on an unsustainable course.

Senator BUNNING. OK. Current CBO practices assume that any law that increased spending will be permanent. On the other hand, current CBO practices assume that any tax decrease will not be permanent. Do you have any plans to address this inconsistency?

Mr. ELMENDORF. I am not yet an expert, Senator, on the logic underlying all of the scoring practices that CBO has followed over the years, so I am aware of the statement that you make, but I cannot offer at the moment a full justification of them. I think we are always interested—our goal is to be as transparent as possible about what is happening in the Federal budget and to offer as—and when we offer budget forecasts, to make those forecasts as revealing as possible. And that means both perhaps our judgments about what is going to be useful to this Committee, to Members of the Congress, to members of the public.

So I am happy to talk with you about those issues in the future, but I do not have any plans to make changes at this time.

Senator BUNNING. I would like to get back to something that the prior Senator brought up, the new Senator from Oregon. There occurs when you make an adjustment in mortgages and you adjust from 100 percent say to 75 percent, there occurs a capital gain to the unfortunate person that gets that. Yesterday, we tried in Finance to erase or to mitigate some of the circumstances of that—unsuccessfully. We are still working on it with the help of Senator Conrad, obviously, who brought the bill—or the amendment to the bill that we were working on, the stimulus package. But there is nothing, unless we change the tax policy, that can eliminate, if you adjust those mortgages from 100 percent to 80 or 75 percent, from that capital gain that now has to be paid on the forgiveness unless we adjust, as Senator Conrad had suggested yesterday, a tax holiday or allowance for that capital gain to be taken out.

You realize when we passed the Freddie and Fannie unlimited Federal Government assistance and the $300 billion in FHA assistance, we thought we were actually solving a problem. But we put too many restrictions on the FHA money, and we have only had 111 people—can you believe that?—out of 5 million that are in trouble with their mortgages apply for that FHA assistance. We have got $300 billion sitting there to help them with their mortgages. We have only had 111 ask for assistance.

Do you have some suggestions—I am almost finished with my time—on how we could adjust that?

Mr. ELMENDORF. I think the changes are already underway to try to improve the deal, if you will, from the perspective of private lenders. But it is another reflection of the intrinsic problem here, which is that if a set of homeowners bought houses for $200,000 apiece and they put 10 percent down, so they borrowed $180,000, and now the price of the house has fallen below the $180,000, that nobody wants to admit to the loss in that. And if we think the crucial way to keep people in their homes is to get the value of the mortgage they owe down below the new value of the house, which evidence suggests is important in keeping people in their homes, then either the private lenders have to agree to write down the amount that they are going to receive—and, again, that makes sense for them for people who would otherwise, in fact, default, but not for all those who would otherwise keep paying, and it is hard to distinguish them. Or the Government needs to come up with that money to help subsidize the writedown. That is a very expensive business.

What happened in the Hope for Homeowners Program was that the effective Government subsidy, when all the different provisions were sliced and diced, was pretty small, a couple percent, and that is partly why CBO, in fact, estimated that the take-up would not use nearly the $300 billion, although the take-up has been even lower than CBO and other analysts expected.

Senator BUNNING. Way lower.

Mr. ELMENDORF. Yes.

Senator BUNNING. Well, we have to adjust that so that more people can be available for that.

Mr. ELMENDORF. Right. But there are a number of ways to change the parameters in that program that could induce more take-up, and I think most people would think that would be a constructive——

Senator BUNNING. Thank you very much, Doctor.

Mr. ELMENDORF. Thank you, Senator.

Chairman CONRAD. Thank you, Senator Bunning, and thank you for your reference to what we attempted to do last night. We did get a commitment from the Chairman to work with us. I think it is very, very important what Senator Bunning was talking about, if I could just give briefly an example.

If you have a million-dollar issue, you have got a million-dollar commitment, and you renegotiate to $800,000—and this can happen in a mortgage; it can happen in a business loan—that creates a $200,000 taxable event. And that is one of the problems that is locking up business activity right now.

So we are hopeful that we are going to be able to make some progress on this before we get to the floor. It is very costly. The amendment that I offered last night costs $14 to $16 billion, was the estimate. I personally think it is one of the things that is going to have to be done.

We will go next to Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and I look forward to working with you and Ranking Member Gregg on this Committee.

I would also quickly add that you gave me a kind introduction. I also, when I was Governor, loved charts and graphs, so I hope I can participate in those activities as well.

Dr. Elmendorf, thank you. I know we have got a vote, so I have three separate areas of questions: first around transparency, second around the housing market, and third around the credit markets. And I know we may be short on time.

First, on transparency, I am really happy to see your presentation because one of the things that has driven me crazy on particularly the already existing actions is the lack of transparency to the American people about how these dollars have been spent or invested. And folks in Virginia think that the first round of the TARP we have totally flushed it down the toilet, when in reality hopefully we may have some discount, but there may be some return. I see there are 214 institutions we have invested in. You have laid out some of the terms and conditions of the major institutions.

Why couldn't we have a website that would portray by institution what we have invested, what the terms and conditions are, and how we are doing based upon other like kind preferred shares, for example, so that the American people could track our investments on a daily basis? You obviously have been able to do that. Could that not be done by the administration or by someone to get this information out?

Mr. ELMENDORF. Yes, I certainly think it could be.

Senator WARNER. I know we pressed the new economic team of the President to do that, but this is the first time I have actually seen this kind of data out there. So it is very helpful.

Second, and following up on both Senator Bunning's and Senator Merkley's comments on the question of the housing area, as we

think about mortgage writedowns, whether through the cramdown process of bankruptcy or renegotiation, what are the challenges and how much of this is a new area? Because we have had not only a dramatic increase of securitization, but as we have taken these loans and sliced and diced them in so many ways and added so many new instruments trying to adjust that last 2 to 5 to 10 percent of debt with some of the CDOs and other things off to the side, that even if you do not have, one, the single party to negotiate with across the table and, two, even if you then do have an ability to renegotiate down, how that differential between—using the Chairman's example of the 100 down to 75, how that loss is spread so they do not end up with years of lawsuits. Has anyone been looking more closely at the mechanics of that process?

Mr. ELMENDORF. A lot of people have been working on it. I think the basic problem is that when all the securitization and further complications took off, people did not anticipate needing to renegotiate the mortgages. So the servicing agreements do not deal with it very effectively. They are not always clear about what rights the servicer has. They provide no mechanism for the servicer to be paid for the extra costs that they incur in trying to modify mortgages. And that is a mistake that is hard to remedy now.

But I think beyond that, as I said, even if it were just Jimmy Stewart the banker across the desk from an individual, there is still the problem that whether that individual is going to—many of those individuals who are underwater will keep paying, even without modification. Some will not. I think all the mortgage plans that are being discussed try to find some way to identify the ones who will not be able to pay and help only them. But it is difficult to target it that well, and that is partly why the costs get large.

Senator WARNER. One of the things that was talked about, earlier you heard a lot of conversation about but you hear less now, is the question of mark-to-market accounting rules and whether there ought to be some kind of holiday so that as these financial institutions do not have to continually re-mark down their portfolio, perhaps even below what the actual asset value is, which ends up meaning that if we do recapitalize, those dollars cannot be used to lend out, they have to be kept on reserve. You got a feeling on any of that mark-to-market debate?

Mr. ELMENDORF. I think there is some diversity of views among experts on that. But I think the majority of experts actually lean toward maintaining mark-to-market rules.

One of the key problems now is the lack of clarity about what institutions' financial condition really is, and the more we move away from mark-to-market accounting, for all of the flaws of whatever the current marks would be, the less clarity that we get. And one of the virtues, for example, people see in the Swedish plan was that they enforced mark-to-market strictly and through that mechanism seemed to have revealed which institutions were viable and which were not, and they closed the ones that were not, and they supported the ones that were.

So I think, on balance, most analysts actually favor the mark-to-market rules, despite all the various problems, as the most effective way to gain clarity about what is going on now as a way to then move forward.

Senator WARNER. And I know our time is short, but one last question on the credit markets. It seems to me that one part of the debate that has been missing, at least from the legislative standpoint, has been that as we think about the President's reinvestment plan, one of the areas that has stymied job growth and reinvestment opportunities is the freezing of the municipal and any other kind of public bond markets, whether your housing authority markets, your local school division, or your State transportation bonds. And I for one think, you know, these are projects that are ready to go, and with the appropriate risk assessment, you know, that the Fed or the TARP could—funds could be used to either be purchasers or to be insurers of last resort and jump-starting that public market. We have done a lot in the commercial paper area, but jump-starting those public financing markets could have job benefits, would have community benefits, and if we put the right type of insurance on this, would not have great exposure in terms of public funds.

Have you all looked at those public bond markets?

Mr. ELMENDORF. I think you are just right that those markets are suffering from some of the same problems afflicting other parts of the financial system, have received less policy attention. I believe that the Federal Reserve is more restricted in what it can do regarding those securities. The clause of the Federal Reserve Act that refers to their extra powers under unusual and exigent circumstances does not refer to loans to other governments. It refers to loans to private borrowers. So I am not a lawyer, and I do not know exactly, but I think that there are limitations on what they can do, and it may be part of why they had not pushed ahead in that direction——

Senator WARNER. Not the Federal Reserve, but the TARP pressed.

Mr. ELMENDORF. But the TARP could take action.

Senator WARNER. The irony is that these are projects that are ready to go, that have a readily identifiable ability to be repaid—and yet they are not being put to bed and being funded.

Mr. ELMENDORF. Yes, I think that is right, sir.

Senator WARNER. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

I would just say to colleagues there are about 5 minutes left in the vote, so I think we better take a recess. I think that is the most appropriate thing because I do not know if Senator Murray may have additional questions. I do.

Mr. ELMENDORF. OK.

Chairman CONRAD. So if you do not mind, we will take a 15-minute recess.

Mr. ELMENDORF. I will be right here. Thank you, Mr. Chairman.

[Recess.]

Chairman CONRAD. The hearing will come back to order. I apologize to Dr. Elmendorf. As you know, in the Senate when a vote is called, we respond, and it is always somewhat unpredictable, when a major bill is on the floor, when votes might occur. They are telling me that we may face another vote at 12:10. So I think in fairness to my colleagues, I will not go to my second round until everybody is finished a first round. Senator Nelson has joined us. Are

you ready to go, or would you prefer—you would defer to Senator Warner.

Senator Warner, if you would like to go to your second round?

Senator WARNER. Mr. Chairman, I will let you go first—you could say I am getting used to this when I said, "Mr. Chairman, I will let you go first." I would be happy to follow in any order you would ask.

[Laughter.]

Chairman CONRAD. OK. I will go to my second round and try to be brief about it.

Dr. Elmendorf, the great concern I have as I look at where we are with respect to the second half of TARP and the economic recovery package, is that we, in effect, have been siloed in these two pots of money without sufficient coordination between the two. And when I review what I believe are the needs for the financial sector and housing—and I am repeatedly told, well, don't worry about those being addressed in the economic recovery pot because they will be addressed in the second half of TARP. And I look at what remains in the second half of TARP, less than $350 billion, which is an extraordinary sum of money. But when I look at losses in the financial sector that I am told may be approaching $1.9 trillion, and we have put out $350 billion so far, that is a yawning gap.

Can you help us understand your sense of how big and how deep the hole is and how much of it may have to be covered by Federal—by taxpayer resources?

Mr. ELMENDORF. I am happy to offer a qualitative sense of that. Estimates of the total losses to be suffered by financial institutions vary widely. Numbers that I have seen—not that we have generated at CBO, but from outside analysts whom I respect—talk about perhaps $2 trillion, as you said, of losses by worldwide financial institutions, about half of that by U.S. institutions, and about half of that already recognized by them. That leaves about $500 billion of losses yet to be recognized, by this estimate, in addition to the fact that even without further losses, institutions are already obviously suffering from loss of capital and inability to do new lending.

So I think the gap that remains in terms of the recapitalization needed by the banking system exceeds the amount of money left in the TARP, I think by a good margin, not even counting the fact that part of the TARP will probably go to mortgage foreclosure relief, as I understand it, and perhaps to other targeted issues.

So the remaining gap is wide. Certainly hundreds of billions of dollars of additional capital will be needed that is not available through the TARP. I think the crucial question is how much of that can come from the private sector and how much will need to be Government funds. That depends on how the program is structured, and that is, I think, very difficult to judge.

For all the discussion that is in my testimony and other places about the need for a strategy now, in fact—and we need one—in fact, it will still be very uncertain just how this will play out and what will happen. But I think the odds are that more money will be needed than has been authorized so far in the TARP, probably to the tune of hundreds of billions of dollars.

Your colleagues will, of course, get to decide, but I think that is what will be presented to you.

Chairman CONRAD. Let me just say that is very much in line with my own kind of back-of-the-envelope calculation here from what I have been able to ascertain, and the problem is it seems to me the number is growing on us, because things continue to fall away. They continue to fall away in housing. The latest Shiller index shows that. They continue to fall away from us in terms of the financial sector. Senator Warner and I were just talking about the story in today's paper about the dramatic loss of valuation in the major banks around the world. It really is stunning.

Mr. ELMENDORF. A stunning picture, wasn't it?

Chairman CONRAD. Stunning. A stunning picture of what we face around the world. And so, you know, I wrote a letter to the administration, to Mr. Summers and Mr. Geithner, and I told them I worry very much that there are not enough resources in this package to deal with the housing crisis, continuing housing crisis, the financial sector, and the need to give lift to the economy, and that I am very concerned that they are going to come back here in several months and say we need this additional several hundred billion dollars. To me, we would be much better off, if that is the case, to reconfigure part of the economic recovery package to better address these other needs and/or to add resources to TARP and to do it now, because I think the mood around here for additional substantial packages is diminishing.

You know, we have been through the rebate, which I do not think worked well at all. The best estimate we have is 40 percent of that money got injected. Then TARP, basically the first two phases of TARP, which, frankly, I do not think worked particularly well, although I think they averted a total collapse. Maybe you could give us your estimates on that. What would have happened absent the injection of capital provided for in TARP 1?

Mr. ELMENDORF. I think that absent that injection of capital, the financial system would really have broken apart in a way that we have not seen, at least since the Great Depression in this country. It is very hard to know if we do not have historical experience here to compare it to, really. But I thought the period between the collapse of Lehman Brothers and the move toward the TARP was a frightening one in terms of the financial system. And a strong financial system is a key foundation stone of a strong economy.

So I think it was very worrisome. I think it is hard to know where the TARP—what the TARP money did because we do not observe the world without it. Moreover, it is hard to track, impossible to track any actual dollar that is injected into a large complex institution and see exactly what that dollar accomplished. But I think the sense on the part of some people that the TARP did not work because we have not fixed all of the problems in the financial system I think is misleading, and there are certainly particular aspects like interbank lending where conditions have markedly improved, and that is the thing closest to the institutions the TARP was designed to help.

Chairman CONRAD. Are you referencing there the TED spread?

Mr. ELMENDORF. Yes.

Chairman CONRAD. That improved quite dramatically. It was nine times what was typical at the height of the crisis. It has improved substantially from there, but it is still nowhere near normal.

Mr. ELMENDORF. Right.

Chairman CONRAD. And, yes, my own belief is, absent the first TARP, the system would have collapsed. And I believe the Dow would be probably in the 4000 range today if we had not done it. I believe that the point that many make—and I have made—that we did not get the expansion of credit that we would have hoped for also perhaps does not take account of how serious the impairment of capital was to these major institutions. And absent those injections, they would have been calling good loans right, left, and sideways to rebuild capital. Is that your——

Mr. ELMENDORF. I think that is exactly right. They have lost a lot of capital, and on top of that, they are trying to reduce their leverage in response to the greater risks in the world. The combination of those things would lead, without public policy, to a very sharp decline in total loans outstanding, on the order of trillions of dollars. And to offset that, that is the basic reason for trying to intervene in the financial system now.

So I think the judgment of most economists is that the TARP money did as much as the few hundred billion dollars would do, and that is a stunning statement given the amount of money. But it reflects the scale of the problem.

Chairman CONRAD. Well, I do think that is part of the problem here, yes, $350 billion is a staggering amount of money. Staggering. But you put it up against the losses in the banking sector in this country alone approaching a trillion dollars, and that is a mighty deep hole to fill.

Senator Sessions.

Senator NELSON. Would the Chairman yield and let me do a followup to that question right there?

A variation of your question is: What if the first tranche of $350 billion had been used just to go to mortgages, where would we be?

Mr. ELMENDORF. I think we would be in a better place in the mortgage market, but a much worse place for the financial system and economy as a whole.

Senator NELSON. Why is that?

Mr. ELMENDORF. Because bank lending is important for all of the pieces of economic activity. It is important for mortgages, but also very important for consumer loans of other sorts, and extremely important for business activity—and not just business investment of the sort we might think of needing a loan for, but even for regular business operations. I think all of that was endangered by the breakdown in the banking system that we were witnesses to last fall. And I think the TARP money, in the judgment of most analysts, avoided a real calamity in the financial system as a whole, and thus in the economy as a whole. But as you were pointing out, Senator, it did not do much directly about the mortgage problem.

Chairman CONRAD. Senator Sessions.

Senator SESSIONS. Well, you know, I was home with my 90-year-old aunt this weekend. She has macular degeneration and cannot

read the paper, but listens to the news. And she said, "You all don't know what you are doing up there, do you?"

And you say this, Mr. Elmendorf, but I've just got to tell you, a lot of people think the first $350 billion did very little. And, in fact, we were told one thing, and within a week we were doing another. And so for anybody to suggest that this has been a very, very carefully constructed expenditure is—I do not see how they can make that case. Wouldn't you agree it has been hit or miss?

Mr. ELMENDORF. My 75-year-old mother has a similar reaction as your 90-year-old aunt, Senator. I did not say that it was well constructed or carefully considered. I think it was an emergency response to an emergency.

Senator SESSIONS. Well, I know the excuse is, well, it was an emergency so we do not care, we did something, and that is politically of value, and nobody can prove it wouldn't have been a lot worse if we hadn't. But I will leave that issue aside.

You have worked in the CBO and you have worked in the Treasury and you have worked, I believe, in administrations before, and at Brookings, which is a well-respected institution. So I would just ask you, you fully understand that Republicans and Democrats, liberals and conservatives, free market and Government interventionists have to depend on CBO's numbers, and that integrity and honesty and consistency is expected of you, do you not?

Mr. ELMENDORF. Yes, I understand that. We take that responsibility very seriously at CBO.

Senator SESSIONS. And I appreciate that, and I would just ask you, are you committed to that service to America?

Mr. ELMENDORF. Yes, absolutely. I am honored to have the opportunity, and I would not have been interested in this job if that was not the role that I wanted to play, Senator.

Senator SESSIONS. Thank you. And I am sure you are committed to that and all, but we are a little nervous around here about the way money is being thrown around. And the Chairman is asking some very serious questions.

Looking at CBO's budget outlook, they are showing that in 2014, which I guess is 4 or 5 years from now, that the net interest on the debt—that is on page 16 of Budget Outlook that you sent out that I am looking at. It has $392 billion, almost $400 billion. In the next year, it is $418 billion in interest on the debt alone.

Now, Mr. Chairman, I know the Bush administration was savaged for the money that it spent on the war in Iraq. That is about $500 billion over the whole time of the Iraq war. So we are going to be at an annual interest payment of around $400 billion in 5 years. And that does not include the stimulus package, the $900 billion stimulus package, which we have gotten some recent numbers from CBO on that. I guess it shows $38, $37 billion more by 2014. So we are really at about $430 billion per year by 2014.

Can you share any thoughts with us on the impact of that, I guess in the financial markets, what kind of uncertainties that creates? I know you have projected an interest rate for this, and you do the best job you can to project, and we do not know for certain. But what are the factors that impact the interest rate we might be paying on our debt 4 or 5 years from now?

Mr. ELMENDORF. At the moment, Senator, our country is experiencing a bit of a reprieve in terms of the financial market scrutiny of our long-term budget imbalance, and the reprieve is coming because investors around the world are scared of risks in many private financial assets, and U.S. Treasury securities are still viewed as the gold standard. So people are moving money into Treasury securities from other U.S. assets and from other assets around the world. That has actually helped to hold down our interest rates for the moment. It is undoubtedly a temporary reprieve, and no one can be sure when the reprieve will be lifted.

Senator SESSIONS. These are about as low as we have ever had historically in modern times?

Mr. ELMENDORF. They are very low. And most analysts expect that as the economy in this country and around the world emerges from the recession, the fiscal imbalance will start to register more prominently in the minds of investors, and that they will become more leery of investments in this country and will not want to hold so much Treasury debt, and at that point interest rates will rise.

There is a risk of that happening at any point. It is a matter of confidence in many ways, and of all the things that economists model badly, confidence is one of the worst.

So there is a risk at any point that people could get concerned, more concerned than they are. I think people understand these numbers in an intellectual sense. I do not think it is operating on their investment decisions at the moment because they are more worried about something else. But at some point, they will become more worried about this, and at that point, the consequences for the U.S. economy will become more apparent. And I think that is why CBO has said one of the criteria for effective fiscal stimulus is to not worsen the long-run imbalance in the budget, and that is partly because of the long-run costs but also because of the risk that if the long-run imbalance is viewed as drifting even further out of control, we could be sparking some concern and, thus, sparking some more immediate reaction that would cutoff part of the recovery.

Senator SESSIONS. It seems to me that it is pretty much a temporary thing that people would loan money to the Government, buy bonds and treasuries, at an interest rate of less than 1 percent, because they eventually will just want more return. And also, the capital surge around the world, from oil in the Middle East, for example, is way down, so other countries' ability to buy even if they wanted to buy would be down. The Chairman showed a New York Times article that said China's surplus dropped from $50 billion a month to $20 billion, so even if they wanted to buy, they do not have as much money to buy.

So are those factors that might cause a spike in interest rates?

Mr. ELMENDORF. Those factors are certainly relevant. I think the thing which is providing the funds is that consumers and businesses around the world are doing less spending. So think of our consumers who suffered big losses, perhaps, in the value of their homes, big losses in any stocks that they hold. That is trimming consumption considerably. That is part of what is leading us deeper into this recession. But, also, it does raise saving a bit at the moment. The personal saving rate is rising a little in this country. So

it is the move toward less spending and more saving around the world that has provided the funds to buy our debt. But you are absolutely right that the decline in incomes people are experiencing is working the other direction.

Senator SESSIONS. Thank you. Mr. Chairman, I appreciate our Director, and like Mr. Sunshine, I can understand his answers.

I thank you for that. Sometimes around here, our experts are awfully obtuse.

Chairman CONRAD. I would say to the Senator that in the interview process, which is, as you know, conducted by the Chairmen and Ranking Members of the Committees and our staffs, I think you would have been very, very pleased with Dr. Elmendorf. He is a straight shooter, tells people when he does not know the answer. As you know, his job is not to give us policy advice.

Senator SESSIONS. Right.

Chairman CONRAD. But to give us analytical advice, and I tell you, I think I can speak for all four of us. It was an impressive set of interviews.

Senator Nelson.

Mr. ELMENDORF. Thank you, Mr. Chairman. Thank you, Senator.

Senator NELSON. For this next tranche of $350 billion, what would you prefer it to go into, a Federal guarantee protecting the banks against the losses on assets that are backed by the failing mortgages, or would you want to set up some kind of Government institution to buy the toxic assets?

Mr. ELMENDORF. Well, as the Chairman just said, I do not offer policy advice, but I can tell you, I think, some of the consequences of choosing different courses of action here.

Without significant injection of Government funds to subsidize mortgage modifications, the pace of modifications will remain small relative to the number of people heading into foreclosure. At the same time, without substantial injection of Government funds into the banking system, the banks will remain preoccupied with their past losses. Private capital will stay on the sidelines, fearing both the unknown in the banking system and the unknown of possible future Government action. And with the banking managers trying to keep their heads above water and private capital not coming in, bank lending will be significantly restricted, and that will raise the cost of credit and lead to less private spending.

Senator NELSON. So your answer is basically we are going to have to do both.

Mr. ELMENDORF. I think that is the experience we have seen in other countries. The savings and loan crisis cost us basically 2 percent of GDP. But as large as that seemed at the time, that is not as significant as the problem that we face now. And other countries that have faced serious financial crises have spent very large amounts of money to get out, and those that have waited to do it have spent more and spent longer in that period of recession or severe economic weakness.

Senator NELSON. Look backward and tell me with the problem having been to begin with the bad mortgages that were securitized and sold throughout the financial system, if our first response had been let us send this money in there to buy up these toxic assets, when would that have worked without having to go and start bail-

ing our banks in the continuum of time as the problems unfolded last year?

Mr. ELMENDORF. At the time, when I was a private agent making recommendations, I was one of, I think, a chorus of economists who supported the idea of equity injections into banks instead of asset purchases. The logic was essentially that setting the price for the assets was a very difficult business. Much of the toxic securities are not widely traded, so market prices are not available. And deciding how much to pay would matter very consequentially for the cost to taxpayers, the benefits to bank owners, and might matter differentially across bank institutions. So we——

Senator NELSON. OK. Wouldn't that then necessitate having the savings and loan approach that we had, go in and buy up those bad assets and hold them then until the price came back up?

Mr. ELMENDORF. One important difference in the savings and loan situation is that at the time, the assets came to the Government automatically in the sense that we had a FDIC guarantee of deposits, when institutions failed, to honor the guarantee. The FDIC put the money up—and in the savings and loan, as well, of course, the FSLIC at the time—put the money up, and the assets came to the Government. And they were managed in a way that I—there were debates, in fact, about how quickly the assets should be sold, but managed in a way to try to maximize taxpayer return.

The harder issue now, I think, at the moment is at what price one brings those assets into the Government. One can wait for the banks to fail, and then in a sense we get them all automatically. But I think the concern among most observers is that we do not want to wait because that pulls the economy down faster. So it is deciding the price to go out and get them or, another way, that would be how much to charge for the guarantee. And I think there is a tough tradeoff. We do not want to benefit the managers and owners who made bad decisions. On the other hand, if we let them sort of stew in their own mess, then we run the risk of driving the economy further into the ground. And that is what makes that decision of what to pay hard.

The virtue of equity investments was that you could do a lot of money very quickly without making those choices. I think in retrospect that did work to stave off immediate collapse, but it does not solve all the problems. That is why we are back here today.

Senator NELSON. If you had a Federal guarantee protecting banks against those losses that are backed by the bad mortgages, would that then not require the Federal Government to put capital into banks and, therefore, the nationalization of banks?

Mr. ELMENDORF. I think it could avoid putting in capital now. Of course, the essence of the guarantee is we might have to put money in later. And CBO is in the process of developing techniques for estimating the cost of guarantees. So that cost could be substantial—I mean, very uncertain but potentially expensive down the road.

I think the issue on ownership, the economists who have advocated equity injections did it not because they wanted the Government to be the owner of the banks in terms of running the banks. Most of the proposals were very explicitly not for majority stakes or direct control. It was viewed as a way of putting money in that

would be roughly evenhanded across institutions and could be done quickly.

But you are absolutely right; the more of that that is done, the larger the stake that the Government takes, the more the Government becomes the de facto owner. And one implication of this picture that the Chairman referred to that showed how much the market value of banks has shrunk over time is that, in fact, the sorts of money that we are talking about them needing would buy a very significant share of the equity of some institutions.

So that is, I think, an increasing challenge. As more money goes in, then the share that the Government owns goes up. Then the issues you raise become even more acute.

Senator NELSON. So if you buy up the toxic assets or, in the alternative, you guarantee the toxic assets, you are still saying that we are probably going to need to put money into banks anyway, which means we are going to get preferred shares and so forth for the Federal Government.

Mr. ELMENDORF. Eventually, I think that is right. The essence of the problem is that they have lost, and to make the system move on, money needs to be added.

Senator NELSON. That is bad news, Mr. Chairman, and I just want to say—so the newly confirmed Secretary of the Treasury is basically—it looks like he is going to have to take this course.

Mr. ELMENDORF. I think that is the expectation of most observers, yes, sir.

Senator NELSON. Either guarantees or buying them up and injection of capital into the banks.

Mr. ELMENDORF. Yes. I would just say I think the third possibility related to guarantees and buying the assets would be what has been described as a good bank/bad bank approach.

Senator NELSON. Right.

Mr. ELMENDORF. In which the bad assets are separated out, but then at that point the Government needs to provide some financing for that.

Senator NELSON. And how much is this going to add to our national debt, Mr. Chairman?

Chairman CONRAD. My own belief is hundreds of billions beyond the commitments that have already been made. Hundreds of billions.

I tell you, I do not perhaps want to talk about it in this setting, but other conversations I have had over the weekend with respect to the financial sector, very sobering stuff.

Mr. ELMENDORF. Yes.

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you very much, Mr. Chairman, and welcome, Dr. Elmendorf.

Mr. ELMENDORF. Thank you, Senator.

Senator SANDERS. And I apologize for not being here earlier. I want to ask you mostly questions about the financial crisis, and then I want to ask you another question about how CBO makes their accounting assessments.

Question No. 1: Between 2001 and 2007, commercial banks alone—not investment houses, just commercial banks alone—made some $700 billion in profit. A lot of money. Now, as a result of the

greed, recklessness, perhaps illegal behavior on the part of Wall Street, they are coming to the taxpayers for huge bailouts, and we have no idea how much that is going to end up costing.

A very simple question. The average guy goes out and has a lot of luck, he wins the lottery, makes a lot of money, puts the money in the bank. Bad times come. He said, "Well, good news. I won the lottery. I have a lot of money. I will pay off my debts." These guys have made unbelievable sums of money. Then through their greed and recklessness, they created a terrible crisis, and now we have to bail them out. Where did all their profits go?

Mr. ELMENDORF. As you know, Senator, the banks have paid out profits in the form of dividend payments to shareholders.

Senator SANDERS. Yes.

Mr. ELMENDORF. They have paid salaries to managers.

Senator SANDERS. Yes.

Mr. ELMENDORF. That money is not directly recoverable legally, but I certainly understand the frustration that the American people feel at the situation.

Senator SANDERS. Yes, they sure do. In other words, some people became incredibly rich, and then when things got bad, it is the average Joe who has to bail them out. And somehow or another, we have to deal with that, and that is why, by the way, in terms of the first bailout, I proposed—I voted against it. I proposed the surtax on people whose families had at least a million dollars in income, because they are the people who benefited from Bush's economic policies in general. All right.

Second question: Taxpayers provide all of these, I guess, "capital injections" into these banks. We are talking $350 billion plus more in the next tranche. And people go to these banks, news reporters go and say, "Tell us what you are doing with this money." And the banks say, "Oh, well, we thank the public very much for bailing us out, but we do not want to tell you what we are doing with the money."

"Are you using this money to lend it out to small businesses to create jobs?"

"None of your business. We will do with it as we want to do with it."

All right. So my question to you is: Why is there not—why haven't we forced transparency and demanded that these banks lend out the money as they were supposed to do rather than perhaps use it for bonuses, for mergers, acquisitions, et cetera?

Mr. ELMENDORF. I think as an analytic matter, Senator, it is very difficult to track what happens to a dollar that goes into a very large and complicated institution. A lot of money goes in and a lot of money goes out of these banks. Knowing what was done with a particular dollar is really, I think, an almost unanswerable question.

There is also a broader problem, which is that we do not know what would have happened otherwise. So economists talk a lot about the counterfactual situation.

Senator SANDERS. Right.

Mr. ELMENDORF. Without the money, what would have happened?

Senator SANDERS. But don't you think if I give you—you come to me and you say, "Look, I need a lot of help," and I am saying, "OK, I am a nice guy. We are going to bail you out." Don't I have a right to have—understanding what you said—you telling me, "Well, look, in general this is what I am doing. I know you wanted us to make loans to loosen up capital." Don't you think we have a right to know a little bit more than these banks are telling us?

Mr. ELMENDORF. I think certainly the Government can set the conditions that it wants on these injections, and it did set some, of course, as part of the legislation authorizing the TARP. There will in some cases be a tradeoff between the speed with which actions can be taken and the care with which they are taken. And I think one of the—when the TARP was being debated, of course, there was a great sense of urgency, I think, in the minds of most people watching the financial system, and that may be one reason why more discussion was not made at the time of these issues.

Senator SANDERS. With the exception of our friend Bernie Madoff who pulled off a remarkable—again, it is incomprehensible how you could pull off a $50 billion Ponzi scheme in this day and age without being detected by the SEC. Do you believe that Wall Street leaders engaged in illegal behavior and that some of them should end up behind bars in the coming years?

Mr. ELMENDORF. I think it is very appropriate to prosecute people who have broken laws. I am not a lawyer. I do not really know securities laws. So I am not a good judge of what has happened. I think where there is lawbreaking, it should be addressed.

Senator SANDERS. Well, that goes without saying, but, you know, people break the law, we generally try to prosecute them.

I think there is an outrage on the part of the people, Mr. Chairman, that is not necessarily perceived here in Congress. The recklessness, the greed, I suspect the illegal behavior of maybe a few hundred, a few thousand people has impacted and destroyed the lives of millions of people in this country. And in my view, they have got to be held accountable, and I am concerned that because they are rich and powerful, they do not get the same treatment as the average criminal. But I think we have got to address that issue.

Chairman CONRAD. Senator, if I could just interrupt, and it will not come out of your time, just on this issue, I think you are right. I think we will find lawbreaking. I think we will find criminal wrongdoing. I think people should go to jail.

I have written the Attorney General, and I have asked that in every one of these cases where Government funds are infused that there be an investigation and that people be held to account. There have got to be prosecutions of criminal wrongdoing, and it is breathtaking.

Senator SANDERS. It is.

Chairman CONRAD. I think we are going to find a lot.

Senator SANDERS. Do you know the what problem is, Mr. Chairman? It is that the amount of money is so huge that nobody can get their hands around it. If somebody robs $50,000, we understand the problem. What are we talking about? Trillions of dollars? What is a trillion dollars? Nobody in America understands what that is.

So the problem is so big that I think we have not focused, as the Chairman said, on potential illegal behavior and what we are going to do to these people.

All right. Let me ask you another question. We have talked primarily about TARP funds, but there is another huge source of funding from the Fed, which I think you estimated to be over $2 trillion—$2 trillion, a few bucks here or there adds up—which is going out to whom? I mean, I do not quite understand how over $2 trillion can be lent out—Mr. Chairman, I am not quite sure that we know who is receiving this money. We do not know what the terms are. How do you lend out $2 trillion of Federal funds through the Fed and nobody knows anything about this? Dr. Elmendorf?

Mr. ELMENDORF. Well, the way you do it is that you try to save a financial system that consists of tens of trillions of dollars, hundreds of trillions of dollars of derivatives outstanding—I mean, the numbers are very large. We have a very large economy with a very, very large financial system.

I agree with you that making clear to Members of Congress and to the public what the money is doing is important. I am not—I do not, of course, want to speak for the Federal Reserve. I think in many cases the terms are disclosed when they have released new—when they have announced new facilities, as they call them, to lend to particular institutions with particular types of collateral or——

Senator SANDERS. Let us not get too complicated here. Does anybody know, has it been made public, who has received this $2.3 trillion and under what terms? Is that public information?

Mr. ELMENDORF. I think some of that is public and some is not. So some of the institutions that have received help are disclosed. Others are not.

Senator SANDERS. But don't you think it is a little bit weird and a little bit undemocratic that the taxpayers of this country are providing help—maybe it is good, maybe it is bad, maybe it is right. How do you know there are not huge conflicts of interest? How do you know you are not giving money to your friends if we do not know anything about it? We argue here, we have 2-hour debates on a 450 million dollar appropriation. You are talking about trillions of dollars. I do not know—maybe the Chairman does. I do not know if you have information—you do not have information either.

I mean, I think it is incomprehensible, but tell me why you thought it makes sense.

Mr. ELMENDORF. Again, obviously you could ask members of the Federal Reserve Board to come testify to you and to explain what they have been doing. I think one argument that is worth keeping in mind for not disclosing everything is concern about the stability of institutions. One of the reasons why the Federal Reserve's discount window, which stands ready to lend to institutions at an announced rate, does not have a lot of institutions that turn up is because those institutions are concerned that revealing their borrowing will cause a run of sorts on the institution.

Senator SANDERS. Well, I do understand all that.

Mr. ELMENDORF. One advantage of the Federal Reserve's facility that did not reveal who was getting those kinds of loans, one of the first things they did was the institutions would feel free to come without risking that kind of——

Senator SANDERS. I really do understand that, but on the other hand, I think the average person would think it is incomprehensible, again—of course, that is the word we keep using about this whole financial disaster—that trillions of dollars are being lent out without transparency or accountability.

All right. Let me switch gear and take you to a more mundane subject. We are off of this huge financial disaster. There has been a criticism of the CBO for a number of years—and I know you have a tough job. You have to assess how much—if I introduce legislation, how much is it going to cost the taxpayers? That is fair enough.

The problem that you have is sometimes legislation is introduced which will cost a certain amount of money, but it actually will save money. I will give you an example.

We are going to introduce very shortly legislation to build a number of—to greatly expand the number of community health centers around this country focused on primary health care, preventative health care. A lot of studies out there suggest that by keeping people from going into an emergency room, keeping people from going into a hospital, cuts back on Medicaid, cuts back on Medicare expenditures, not to mention expenditures in the whole health care system, that really you save substantial sums of money.

So if I introduce this and the cost goes—what it will cost us is going from $2 billion to $8 billion over a 5-year period, how do you assess—I think we can make the case that we are saving taxpayers money. How do you put that into your equation in analyzing how much that legislation costs or saves?

Mr. ELMENDORF. Our objective is very clearly to include all of the ramifications of legislation in our reports to you. I was just meeting for the first time the day before yesterday with people at CBO who estimate costs for SCHIP—heading toward, I guess, being just CHIP—and one of the very important factors they keep track of is how people move between Medicaid and SCHIP depending on the rules and how the States respond, how private individuals respond. We keep track of people moving from private insurance, looking at how employers respond——

Senator SANDERS. But if we do something——

Mr. ELMENDORF [continuing]. And we try to incorporate all of that.

Senator SANDERS. Do you do things like saying, oh, if a person would go to a doctor early and not end up with a terrible illness that we have to spend $100,000 in the hospital for, that is a saving?

Mr. ELMENDORF. Yes.

Senator SANDERS. Do you guys throw that into the equation?

Mr. ELMENDORF. Yes. That is certainly one of the ramifications that we are trying to capture.

Senator SANDERS. OK.

Mr. ELMENDORF. Now, we do not always have evidence consistent with the intuition that we or others——

Senator SANDERS. No, and I——

Mr. ELMENDORF. But where we can find evidence, we work very hard to incorporate as many different effects in the interconnected world as we can.

Senator SANDERS. The criticism, Mr. Chairman, has been that it is pretty easy, if my bill goes from $2 billion to $8 billion, we are spending $6 billion. That is pretty clear. But we are also saving substantial sums of money, and I understand that part of it is a little bit harder to determine. But I hope you give serious thought and build into your analysis the savings as well as the expenditures.

Mr. ELMENDORF. We absolutely do everything in that direction that we can.

Senator SANDERS. Good.

Chairman CONRAD. I would say to the Senator, the lights are not on signaling a vote, but a vote is on. For some reason, the lights on the clock are not functioning properly, and my timer is not functioning properly, so we have some electronic problems going on here. So we will draw to a close. I thank you.

Senator SANDERS. I am finished. Thank you very much, Mr. Chairman.

Chairman CONRAD. I understand. I thank very much the Senator for his able questioning.

Let me just say my own belief is not only was Madoff engaged in a giant confidence game, in a giant Ponzi scheme; I believe part of the derivatives market will prove to have been the same thing, these very exotic insurance instruments used to try to guard against downside risk in overly leveraged financial institutions. And, you know, where do all these losses come from? They come from companies not having the capital to back financial guarantees that they made. That is in part what has occurred here, and that is over in the question of derivatives and debt swaps.

I think we have a Ponzi scheme of staggering proportion going on. I have questioned people who are in the business. I asked them a year ago, some of them in these firms, did anybody have any concept of how much risk was out there? And they asserted to me they did not. People who were in the top management of these instruments in global firms. I asked them if any of them could understand—did top executives understand the formulas that were being used to assess risk? They hired a bunch of Ph.D. economists, whom I have high regard for, who wrote formulas. I asked my staff about a year ago to bring me some examples of these formulas. And I must say, I could not make head nor tail out of them. I have a Master's in Business Administration. I have always been very good in math. I could not make head nor tail out of them.

And I said to some of the executives I was with, "Do the executives in these firms really understand these formulas?" Because I would guess most of them have the same business training I do. No. They did not understand these formulas. And these formulas clearly did not assess risk properly. And yet they are making hundreds of billions of dollars of bets around the world, and now these chickens come home to roost.

I am extremely concerned about what I am hearing about the financial system. That is why I think we have got to refocus on the need to effectively deal with that and the housing crisis. If we do not, I do not see how recovery occurs, and I personally do not believe we have yet grappled with this in the most effective way. And I would give you the chance to respond to these observations.

Mr. ELMENDORF. I agree with everything you have just said, Senator. I think there are at least two important points you have raised.

One is that—and not to minimize the illegal actions that were taken by people, but that most of the problem, in the judgment of analysts, is not what was illegal and done anyway; it is what was legal and not understood and was done. It is an immensely complicated business, and lots of people took a lot of risks they did not understand.

The second point——

Chairman CONRAD. Let me just make a second point.

Mr. ELMENDORF. Yes.

Chairman CONRAD. Have you looked at any of these formulas that were written to assess risks with respect to debt swaps and derivative instruments?

Mr. ELMENDORF. I have seen some of them.

Chairman CONRAD. Do you understand——

Mr. ELMENDORF. Senator, I do not understand them either, despite my training. You know, to be clear, when we tell you that we estimate the cost of the TARP injections to be about $200 billion, that answer comes partly out of those sorts of complicated financial formulas. We have people at CBO who are experts at financial economics, which I am not. But one appropriate caution about our numbers is that they are based on models, drawing on historical data, that can be wrong in just the way we have watched the private investors be wrong.

Chairman CONRAD. Let me say on that point, if I could, I personally believe the CBO forecast is overly optimistic. I used to have the responsibility of forecasting revenue for my State, and I had that responsibility for 6 years, and I have seen repeatedly forecasters are wrong at the turns. It is just human nature. We all—I am not being accusatory here. This is human nature, and I have experienced this myself as a forecaster. At the turns, you always underestimate the upside and underestimate the downside. And I think the CBO forecast suffers from that flaw, which I think all forecasters are suffering from. My own belief is the downturn is going to be more prolonged and sharper than most of these forecasts capture. And I will not ask you to defend the forecast because that was made before you were in this position. But I make that observation. That is my own belief.

We really have very substantial responsibility to the American people on our collective shoulders, and we have got to do a much better job than we have done thus far in fashioning answers. That is my belief.

Thank you very, very much for your testimony here today, and thank you very much for taking on this responsibility. We all recognize around this table that you could make a great deal more money in the private sector and that you bring to this work real distinction and great credibility. And we are delighted, and I can speak for Republicans and Democrats who were involved in the selection process. You really shined through.

Thank you very much.

Mr. ELMENDORF. Thank you, Mr. Chairman. We at CBO look forward to working with you and the rest of the Committee.

Chairman CONRAD. We look forward to it as well.
The Committee will stand adjourned.
[Whereupon, at 12:23 p.m., the Committee was adjourned.]

Opening Statement

I would like to thank Dr. Elmendorf for taking the time to appear before the Senate Budget Committee today. As a member of this committee and also the Senate Finance Committee, I will be working quite a bit with the Congressional Budget Office, so I am glad to have this opportunity to get to know him. I would also like to thank Chairman Conrad and Ranking Member Gregg for calling this hearing.

This hearing is entitled "Federal Response to the Housing and Financial Crisis," and I am looking forward to hearing Mr. Elmendorf's views on the crisis and the budgetary impact of the various federal responses.

But because this is also his first appearance before the Committee, I would also like to take this opportunity to ask Dr. Elmendorf some questions on the budget and how he will run CBO. As all the members of this committee know, the Congressional Budget Office is a very important part of the United States Congress. Whether it is setting the budget baseline, analyzing the President's budget, or simply telling us how much different proposals cost, Congress has come to rely a great deal on CBO.

I am certain that there will be many interesting questions touching on a broad number of topics. I look forward to hearing these questions and, most importantly, hearing Dr. Elmendorf's answers to them.

Senate Budget Committee Hearing
"Federal Response to the Housing and Financial Crisis"
January 28, 2009
CBO Submissions for the Record

Questions from Sen. Feingold

1. Please provide further details about what would be helpful to include in such a standard package [for restructuring mortgages] as well as what you think are the most efficient and expedient ways the federal government can encourage foreclosure mitigation this year.

A standardized package could speed up the modification process by reducing the number of decisions and helping to gain the assent of the holders of low-ranked tranches of mortgage-backed securities and holders of second mortgages. One important way that a standardized package could expedite modifications is by using a common set of criteria that address who is eligible for a modification and what forms the modification could take. Any loan modification program must be carefully designed to reduce the perverse incentive for people to go into default to get a better mortgage deal.

Establishing industry standards for modifications might encourage the modification of securitized loans by mitigating two problems. First, servicers have not modified many loans because the pooling and servicing agreements (PSAs) used for mortgage-backed securities typically do not include specific provisions for loan modifications. As such, servicers fear that they will be sued by investors made worse off by the loan modifications even if investors in the pool as a whole benefit. In particular, the holders of the lower ranked tranches are in line to bear any losses from loan modifications before the holders of the highest ranked tranches. Because many but not all PSAs allow servicers to use industry standards for servicing loans, a standardized package that became the industry standard would provide servicers with greater protection from lawsuits. (The threat of loan modifications through bankruptcy would also make investors more receptive to loan modifications.) Second, PSAs typically do not include provisions for covering servicers' costs for performing modifications.[1] A standard package that compensated servicers for their costs of modifying loan would also encourage modifications. (Fannie Mae and Freddie Mac currently provide such compensation to servicers of their loans.)

A standardized package that successfully dealt with second mortgages could also help troubled mortgage borrowers. The holders of the first mortgage and the second mortgage often have substantially different interests and bargaining powers. To avoid the costly

[1] Rates of foreclosure on loans that have been held by lenders and not securitized are about 20 to 30 percent lower than rates experienced by third-party servicers. See Christopher Mayer, Edward Morrison, and Tomasz Piskorski, "A New Proposal for Loan Modifications," (working paper, Columbia University Business School, January 6, 2009), http://www2.gsb.columbia.edu/faculty/cmayer/Papers/LoanModIncentives-MMP-01-06-2009.pdf

foreclosure process, the first-lien holder may have an interest in reducing the payment obligation of the borrower or permitting a short sale. However, a foreclosure or short sale would make second mortgages worthless. Second-lien holders in such situations seek to avoid foreclosure or a short sale because either would eliminate the potential for their loans to regain value if house prices recovered in the future. (A short sale is a sale at a price that is lower than the total value of the mortgages on the house.) Because the priority of liens generally follows the order in which they are recorded, for a refinancing lender to have the senior lien, a second lien must also be repaid or re-subordinated. The second-lien holders, however, may withhold their consent to re-subordination (if required) or threaten foreclosure to bargain with both the homeowner and the first-lien holder. In many cases then, the ability to help borrowers having difficulty may first require coordination and agreement between the holders of the first and second mortgages.

Consequently, a standardized package that dealt with second mortgages, such as providing for payments to holders of the second mortgages, would encourage loan restructurings. Payments could also be made to servicers who reached out to holders of second liens for obtaining the release of the second lien.

A standardized approach cannot help all troubled borrowers. Many homeowners are living in homes that they cannot afford or maintain. Some of those borrowers would be better off if they received some assistance to switch to rental housing.

2. State housing finance agencies (HFAs) are experiencing an inability to obtain credit or find investors willing to invest in their mortgage revenue bonds. . . . What steps could either Congress or the Administration take to facilitate investment in HFA mortgage revenue bonds and restore much-needed liquidity to the HFAs?

State HFAs finance mortgage lending by selling bonds whose repayments are tied to revenues from those loans. Although HFA revenue bonds often benefit from a similar tax-exempt status as do the debt obligations of state and local governments, states are usually not responsible for making payments on, or guaranteeing, HFA debt.

The current inability of state HFAs to obtain credit may be linked to both investor concerns about the future income stream from the underlying mortgages and liquidity constraints in the market for those bonds. In light of the sharp rise in mortgage delinquencies and defaults, investors may believe that there is a greater likelihood that borrowers will default on the mortgages financed by HFA debt.

The liquidity constraints have also arisen from the particular way some state HFAs have structured the bonds. Some attempted to lower their financing costs by issuing a particular kind of bonds whose interest rate was repriced frequently. Such bonds—known as Variable Rate Demand Notes (VRDNs)—were typically sold to money market funds with a guarantee by a bank that the bond buyer would be able to sell back the bond at the date at which the yield was to be reset. Often those repurchase agreements, which provided liquidity to the VRDN market by allowing VRDNs to be readily bought and

sold, were supported by debt insurance. Financial difficulties of both banks as well as bond insurance companies have led banks to charger much higher fees for providing that liquidity.

In addition to measures aimed at supporting the housing market, which would address investor concerns about repayment, the Congress and the Administration could take several measures to increase liquidity in markets for variable-rate HFA debt. Some market participants are pushing for a temporary federal guarantee and for government-sponsored enterprises (GSEs) to purchase some of that debt. (In 1984 Congress banned so-called "federal guarantees" of tax-exempt bonds. However, the ban exempted a number of GSEs, including Fannie Mae, Freddie Mac and others, who could issue letters of credit). Another measure would extend federal capital or an outright guarantee to companies that had been providing insurance and whose credit ratings had been downgraded, thus making banks willing again to enter into repurchase agreements for VRDNs. (Federal assistance to municipal bond insurers could potentially also support longer-term debt of state HFAs.) A third approach would authorize the federal government to act as a buyer of last resort for the VRDNs of state HFAs.

Any of those measures would make the federal government the effective guarantor of debt incurred by public-sector borrowers. However, the Congress and Administration would need to weigh very carefully the benefits to the housing market and broader economy from such intervention against both the budgetary cost of providing that assistance as well as the longer-term drawbacks of rewarding any excessively-risky behavior that had allowed the bond insurance and VRDN markets to develop to a point where the parties involved are now facing serious financial difficulties.

Question from Sen. Warner

Has anyone done an assessment of how much of the trillion dollar loss discussed is due to actual loss as compared to loss based on current market distortions? For example, in locations where there are no markets for home sales, we are experiencing a phenomenon where prices are falling below real value. A home purchased for $100,000 may have a real value of $75,000, but because of the current crisis, that home is valued at $60,000?

Estimates of expected losses are highly uncertain since they rely on current market prices for houses and other assets as well as assumptions about the future course of those prices among many other things. Some analysts, including those at Goldman Sachs as well as Professors Glenn Hubbard and Christopher Mayer, expect that home prices will fall below long-run equilibrium values due to an oversupply of houses, momentum, and falling sales volumes.[2] However, while the argument is plausible, it is very difficult to determine what the current "real value" might be. Ultimately, a home is worth what people are willing to pay for it, and ,over the next few years, we'll gain some insight from

[2] Christopher Mayer and R. Glenn Hubbard, "House Prices, Interest Rates, and the Mortgage Market Meltdown," (unpublished paper, Columbia Business School, 2008), available at http //www4.gsb columbia.edu/realestate/research/mortgagemarket

seeing what happens to home prices when the period of turmoil is over. Many analysts expect prices to rebound eventually, although probably few if any believe that the prices of houses and mortgage-related assets will return to levels that existed during the housing bubble.

Projections of house price declines are an important part of estimates of financial losses. CBO testified that "according to some analysts, U.S. banks and thrifts could be facing more than $450 billion in additional estimated losses on their assets—on top of the approximately $500 billion that has already been recognized."[3] Sensitivity estimates provide some insights to how losses respond to home price declines. For example, Goldman Sachs's mid-line estimate of $1.1 trillion of mortgage losses assumes another 10 percent price decline. Goldman Sachs estimates that if prices stabilize at current levels, then losses drop to $765 billion, but if prices fall another 25 percent, losses would jump to $1,842 billion.

Financial institutions have not recognized the full extent of their likely losses on mortgages and other securities, such as credit default swaps. Accounting standards give firms flexibility in valuing their holdings in many cases. GAAP is explicit in ruling out valuations based on fire sales. Moreover, firms do not have to mark their private-label mortgage-backed securities to market levels. Instead, firms can use cash-flow models to estimate values because each private-label security is unique. However, while house prices may in some cases fall below long-run equilibrium values. Many analysts believe that financial institutions have not gone far enough in marking down their assets on the balance sheet. The fact that many institutions trade below their book values provides some evidence supporting that claim.[4]

Questions from Senator Murray

(1) "Future Actions Needed to Strengthen Our Financial System"

a. Do you agree with the contention that many of our banks are insolvent and are essentially being sustained through government support?

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[3] For example, Goldman Sachs expects $2 1 trillion of losses on US credits with about half going to US banks. About $1.1 trillion of the losses are expected to be on residential mortgages Richard Ramsden, et. al , "As Mortgage Loss Estimates Continue to Rise, Further Policy Response Likely to Follow" (Goldman Sachs research, January 13, 2009). Also see, Jan Hatzius and Michael A. Marschoun, "Home Prices and Credit Losses: Projections and Policy Options," (Goldman Sachs, Global Economics Paper No. 177, January 13, 2009)

[4] As of November 2008, about half of banks were trading below their book value; frequently the discount was 20 percent or more See Statement of Robert H Herz, Chairman, Financial Accounting Standards Board, before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, March 12, 2009.

Most U.S. banks are healthy. The rescue actions by the Treasury, the Federal Reserve, and the FDIC are aimed at providing temporary liquidity, capital, and support for financial markets. Determining how many of the banks would be insolvent in the absence of the capital injections is a difficult question to answer. In particular, some of the banks may have been able to raise private capital in the absence of federal support. The Treasury is putting 19 large banks—those with total assets above $100 billion— through a forward-looking series of stress tests to determine which institutions are likely to survive the recession and even bigger housing price declines. That exercise will help identify which institutions are likely to become insolvent in the absence of additional capital injections. Some investment analysts expect the stress tests to show that at least some of the large banks will need to raise more capital.[5] The Administration's proposed budget includes a $250 billion contingent reserve for the potential cost of future efforts to stabilize the financial system.[6]

The resources provided to the banks and the government-sponsored enterprises under the Emergency Economic Stabilization Act have provided needed support to the financial system. Without that support, banks probably would have reduced credit by much greater amounts and our economy would be even weaker. The Chairman of the Federal Reserve testified, "Whether further funds will be needed depends on the results of the current supervisory assessment of banks, the evolution of the economy, and other factors." [7]

Economists generally believe that further actions are needed to restore the health of the financial sector. Further, an effective strategy would encourage the participation of private capital. Having a role for private capital is important both because the government cannot provide enough money itself and because private market signals regarding the long-term viability of specific institutions can be valuable. Many analysts believe that policy uncertainty and the lack of transparency about the banks' financial positions are deterring private investors from contributing new capital. If financial institutions are undercapitalized, then it will be much harder to sustain an economic recovery.

b. Do you have any estimates on how undercapitalized the U.S. banking system is today? If we were to continue injecting U.S. banks with capital to sustain their operations, do you have any ballpark estimates on how much funding would be required to get the banks through the bad assets they currently hold?

The Congressional Budget Office does not estimate how much capital banks may need to raise nor have we seen any official government estimates of underfunding. Treasury's stress test may provide better indicators.

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[5] Kevin Horowitz, Steve Foundos, and Craig Singer, "U.S. Banks: Assessing Risk/Reward under Various Stress Test Scenarios," (Citi research, March 2, 2009). Also see, Douglas J Elliott, "Bank Nationalization What is it? Should we do it?" (Washington, D.C.: The Brookings Institution, February 25, 2009), available at www.brookings.edu/papers/2009/0225_bank_nationalization_elliott.aspx

[6] Because the cost is measured on a "risk-adjusted" basis that takes into account future returns to taxpayers, the likely cash injections of capital would be considerably larger.

[7] Statement of Ben S. Bernanke, Chairman Board of Governors of the Federal Reserve System, before the Senate Committee on the Budget, March 3, 2009.

Private estimates show that banks, insurers, and government-sponsored enterprises have raised less capital than their losses reported to date. Bloomberg estimates that U.S. financial institutions have reported over $800 billion of write downs and losses since the start of the financial crisis while raising more than $550 billion of capital.[8] However, over $300 billion of that capital was provided by the federal government. Accounting standards give firms some flexibility on the timing of reporting losses, so that those estimates likely understate the losses that are embedded in their book of business. The fact that many financial institutions have market capitalizations below their book values supports that view.

Looking at private estimates of total credit losses, two estimates have attracted much attention. Goldman Sachs estimated that total U.S. credit losses will reach about $2.1 trillion of which about $1 trillion has been recognized. The loss estimate includes $1.1 trillion in lifetime credit losses on the $11.3 trillion in outstanding U.S. residential mortgages. The remaining losses come from commercial real estate, credit cards, auto loans, and commercial and industrial loans and corporate bonds. Goldman Sachs estimates that approximately half of the total will be borne by U.S. banks and brokers.[9] (The firm estimates that U.S. banks have privately raised nearly $200 billion of capital.) Professor Nouriel Roubini at NYU estimates that total losses from the financial crisis will reach $3.5 trillion of which U.S. banks and brokers will bear about half.[10] Other estimates may be lower than those of Goldman Sachs, while Roubini's estimates are at the upper end of the likely range.

c. Do you agree with those economists who believe non-performing or toxic assets that our banks hold must be addressed as part of any strategy moving forward to strengthen our financial institutions and markets?

Toxic assets are not just nonperforming assets, but also assets whose value cannot be easily determined. Uncertainty about the values of whole classes of assets has frozen the markets for those assets and made investors highly uncertain about banks' future losses from them.

The reason to deal with toxic assets is to enable markets and lending institutions to function normally. Normal functioning of banks requires that they be able to raise capital and borrow in financial markets, so that they can make loans to consumers and nonfinancial businesses. In order to do that, banks need to be able to convince investors

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[8] Those estimates also include losses and capital raised by Canadian financial institutions.

[9] Richard Ramsden, et al , "As Mortgage Loss Estimates Continue to Rise, Further Policy Response Likely to Follow" (Goldman Sachs research, January 13, 2009). Also see, Jan Hatzius and Michael A Marschoun, "Home Prices and Credit Losses. Projections and Policy Options," (Goldman Sachs, Global Economics Paper No. 177, January 13, 2009).

[10] Nouriel Roubini and Elisa Parisi-Capone, "Total $3.6 Trillion Projected Loans and Securities Losses, $1.8 Trillion of which at U.S. Banks/Brokers: The Specter of Technical Insolvency," (*RGE Analyst's EconoMonitor*, January 21, 2009)

of their creditworthiness, which is hard to do when balance sheets contain a significant proportion of toxic assets.

Asset purchases could help determine market values for the assets and thaw their markets, while capital injections further strengthen firms. With more certainty about banks' financial conditions, private investors will be more confident about giving banks more capital. Additional private investment is a key requirement for allowing the government to remove its support of financial markets.

The government already has significant exposure to those toxic assets in the balance sheets of banks and to bad assets formerly held by Bear Stearns and AIG that have been guaranteed by the Federal Reserve (the Maiden Lane transactions). Most bank deposits are explicitly guaranteed, as is some newly issued senior bank debt, and some analysts believe that an implicit guarantee now extends to most bank debt.[11] In addition, the government holds preferred stock in most of the banks and, in many cases, warrants on the common stock.

Several options are available to address the toxic assets. One option is to create distinct institutions, separating an existing (solvent but troubled) institution into a "good bank" and a "bad bank" and isolating the toxic assets in the bad bank. This would allow the good bank to easily raise private capital and to borrow and lend. This option, however, still raises the question of how to capitalize the bad bank and how to set prices for the bad assets.. In principle, the shareholders and the creditors of the original bank could absorb the losses from the bad bank. The bad bank could then dispose of the assets in an orderly fashion rather than risk fire sales. Some form of government support might be needed if there is uncertainty about the financial condition of the bank.

That option would however risk pushing down the prices of toxic assets even further, possibly touching off problems in other institutions at a rate faster than they could be restructured.

Other approaches would more directly require government financial support. In one, the government would provide some type of guarantee on the toxic assets, which would shift the risk of losses to taxpayers (at least to the extent that taxpayers do not already bear that risk). Once the toxic assets had a government guarantee, their liquidity would improve and more their balance sheets would be more transparent. How to price the guarantees to provide some protection for taxpayers would be a critical challenge.

A third option would be for the government, perhaps acting in partnership with private investors, to buy the bad assets, either through reverse auctions or some other process. As we testified, the first problem to be encountered is how much to pay for those assets. This option would help banks primarily to the extent that the government overpaid for the assets. While the transactions might aid in the price discovery process, many analysts believe that such prices would be lower than the current values reported on the banks'

[11] Narayana R. Kocherlakota, "Assessing Resolutions of the Banking Crisis" (University of Minnesota, Working Paper, February 21, 2009), available at www.econ.umn.edu/~nkocher/govtguar.pdf

books. Thus the process could also reveal which institutions are insolvent, which would useful information to policymakers.

(2) "The Coming Wave of Alt-A Resets and Foreclosures"

a. Are you familiar with this looming crisis?

Yes. Resets refer to a scheduled change in the interest rate on adjustable-rate mortgage loans, and could precipitate defaults among both Alt-A and subprime borrowers. Some of the people who borrowed using such loans may have anticipated that they could avoid the reset by refinancing before the reset occurred: as the subprime and alt-A market has dried up that option has disappeared.

The number of subprime loans scheduled to reset for the first time peaked in 2008 at 1.3 million, according to the Federal Reserve.[12] In 2009, about 600,000 subprime mortgages are scheduled to reset for the first time, with another 100,000 scheduled for 2010 Subprime loans that were made in recent years typically begin to reset after two or three years (2/28 and 3/27 loans). By contrast, loans with very low "teaser" rates often reset after a year, while market-rate loans can reset after five years or more (although some reset after 3 years).

The recent fall in interest rates has reduced, but not eliminated, the risks associated with resets on adjustable-rate mortgages. Interest rates on adjustable-rate loans are frequently tied to the London Interbank Offered Rate (LIBOR), a Treasury rate, or the 11th District's cost of funds. Those rates have fallen: the 1-year LIBOR, for example, has fallen by more than 3 percentage points since the end of 2007. On a $200,000 mortgage, that decline would save the borrower about $6,000 a year. Nevertheless, some loans with very low teaser rates could still experience higher payments even with the decline in interest rates.

b. Is there anything other than principal reduction that can be done to address this potential wave of foreclosures?

Foreclosures are driven primarily by two forces: declining home prices and adverse life events that reduce borrowers' ability to repay. Most homeowners who have negative equity do not default or enter foreclosure. At least in the past, a trigger event— such as the loss of a job, illness, or divorce—has prompted defaults. Consequently, the recent economic stimulus passed by Congress should help reduce foreclosures by reducing job loss. Nevertheless, many subprime and Alt-A loans in recent years were premised on the notion that continually rising house prices would allow borrowers to refinance at lower rates as a result of greater home equity. The drop in house prices has left many of those borrowers with "negative" equity, meaning that the total mortgage balance exceeds the

[12] Shane M. Sherlund, *The Past, Present, and Future of Subprime Mortgages* (Federal Reserve Board, Finance and Economics Discussion Series 2008-63, November 2008

home value, and hence no equity with which to refinance. Many of those borrowers cannot sell their homes in the current recession and have mortgages they cannot afford.

Actions that improve borrowers' access to and cost of mortgage credit will also help reduce foreclosures. The Federal Reserve has recently taken a number of steps to bring down interest rates and improve the flow of credit. For example, the Federal Reserve has started buying long-dated Treasury securities to lower the long-term rates to which mortgage rates are tied. In addition, the Term Asset-Backed Lending Facility will be purchasing private-label mortgage-backed securities, which should encourage lenders to extend more housing loans. Both of those actions should provide additional support the housing market.

Removing impediments to loan modifications will also reduce foreclosures, which impose heavily costs on both borrowers and lenders. Borrowers in foreclosure generally have to move and are left with impaired credit. Lenders face large foreclosure costs from legal fees, maintenance expenses, drops in property values and lost interest payments, and selling expenses. However, there are many obstacles to voluntary loan modifications (see next question), which is why federal intervention may spur more modifications. In particular, establishing a standardized loan modification plan may help, as described above in response to Senator Feingold's question.

Private lenders and servicers have been extremely reluctant to reduce the principal on distressed loans, but they have been more willing to lower interest rates and extend maturities. Modifications are likely to increase under the Administration's proposal for a standardized loan modification process, which would be used by all government agencies, Fannie Mae and Freddie Mac, and the banks which receive TARP assistance. That proposal would encourage lenders to reduce the monthly payment (including property taxes and insurance) to a 38 percent debt to income ratio, which would then be matched dollar for dollar by the government down to 31 percent of disposable income. While the plan is aimed at interest rate reductions, principal reductions would also qualify. The proposal would also provide compensation to the servicers of $1,000 for each loan modified plus bonus payments for loans that do not redefault. Absent such payments, servicers have little financial incentive to modify loans because they would not otherwise be compensated for their costs.

In addition, the plan would allow borrowers with conforming mortgages backed by Fannie Mae and Freddie Mac to refinance without meeting the 20 percent equity normally required. Because the existing loans are already effectively guaranteed by the government, waiving the downpayment requirement for refinancing should not significantly increase the government's exposure. This change in practice is important given the large number of recent mortgages that are likely underwater. (By one estimate more than 8 million homeowners were upside down on their mortgages at the end of 2008; that is, they owed more than the current value of the property. Should home prices fall another 5 percent, First American CoreLogic estimates that another 2 million homes will have negative equity.)

The Administration also proposes legislation to allow bankruptcy judges in Chapter 13 filings to "cram down" unpaid principal balances as a response to preventable foreclosures. Bankruptcy judges would be allowed to modify mortgage loans that are underwater by writing down the principal potentially to the current market price, by lowering interest rates, or by changing other terms of the mortgage. (The practical effect of a bankruptcy filing would also be to nearly wipe out any debt attributable to second mortgages.) To the extent that bankruptcy would provide additional benefits to borrowers, they can also expect to pay more for mortgages in the future. The threat of a bankruptcy filing might also change lenders' incentives and make them more willing to modify loans outside the courtroom. Critics fear that handing potentially millions of mortgages over to the judicial system for remedies will increase legal uncertainty and lead to high legal fees.

(3) "Obstacles to Mortgage Workout Programs"

What are the major obstacles that are limiting the effectiveness of these programs? Are there changes that could be made to the existing programs to enhance participation?

The major obstacles to voluntary loan modifications include the incentives facing servicers, investors in the lower ranked MBS tranches, the presence of second mortgages, and moral hazard. Under current pooling and service agreements which control the administration of the MBSs, servicers generally do not receive adequate additional compensation for loan modifications. Moreover, the agreements are often vague about when modifications are in the interest of investors. Consequently, servicers fear that even if the modifications provide net benefits to investors as a group, the holders of the lowest ranked tranches, which would likely absorb most of the losses, might sue them. In addition, the holders of second mortgages generally must agree to accept subordination to the mortgages that are being refinanced and or significantly modified, and they may have incentives to hold up the agreements in order to extract additional some upfront payments. (For example, Fannie Mae and Freddie Mac often pay the holders of the second mortgages amounts ranging from $1,000 to $2,000 or more to agree to re-subordinate.)[13] Another concern is that modifying some loans might adversely change the behavior of borrowers who are currently making payments. The danger is that some borrowers might act strategically and stop making payments in order to qualify for a loan modification.

To overcome obstacles to loan modifications, most proposals involve some subsidies to servicers and some type of loss sharing agreements with investors. In part, those proposals respond to the lack of success to date of FHA's Hope for Homeowners program. Hope for Homeowners is a mortgage-refinancing program, which has so far failed to attract much volume in large part because private lenders are required to write down the value of the loan to between 90 and 97 percent of the home's current appraised

[13] Larry Cordell, et al , *The Incentives of Mortgage Servicers Myths and Realities,"* (Federal Reserve Board, Finance and Economics Discussion Series No 2008-46, September 8, 2006), pp 25-28

value. In many cases, meeting that requirement would result in the lenders recognizing on their balance sheets a substantial loss. Those losses evidentially outweighed the benefits of the federal guarantees on the new principal balance. The Administration's new Home Affordable Modification program for loan modifications would have the government share in the cost of the write-down and compensate loan servicers. Similar incentive payments will be made for Hope for Homeowners refinances, but legislative reforms may be necessary to allow that program to succeed. For example, the Administration proposes that borrowers pay lower fees and that lenders have more flexibility to refinance troubled loans.

Another program, FHASecure, was intended to help homeowners who have adjustable-rate mortgages that were not originated by FHA-approved lenders. The program was designed to allow borrowers to refinance their loans and move into an FHA-insured mortgage if they meet certain eligibility criteria. The program proved to be of marginal assistance and expired at the end of 2008 after helping only about 4,000 distressed homeowners. One problem was that the program did not address mortgages with negative equity.

(4) "Deteriorating Credit Scores Add to Difficulty Accessing Credit"

a. What are the key factors affecting our credit markets today? What can borrowers do to enhance their ability to access credit in this difficult environment?

Markets remain concerned about the value of bank assets. That concern is measured by the still wide interest-rate differential between the rate banks charge to borrow from each other and the rate the Federal Reserve targets for monetary policy. With the economy in a recession and housing prices falling, further impairment of bank assets remains a strong possibility.

Moreover, the securitization channel is severely impaired. Before the financial crisis, market participants readily purchased securities created from mortgage loans, auto loans, unpaid credit card balances, home equity loans, student loans and other lending. Now, for the most part, banks must now hold those loans on their balance sheets, meaning that they need to hold some capital to cover the risks of defaults on those loans. That may explain why bank lending continues to grow, although the rate of growth has slowed. The Federal Reserve is addressing the securitization problem through its new Term Asset-Backed Securities Loan Facility (TALF). Under the TALF, the Federal Reserve will lend funds to private purchasers of top-rate securities backed by such loans; the total amount to be provided through the TALF may be as much as $1 trillion.

Consumers, like the financial sector, are trying to reduce their debt, a process known as deleveraging. Lower debt burdens will contribute to higher credit ratings, which will enhance consumers' ability to access credit in the future when the current recession has ended. Moreover, consumers can improve their credit ratings by becoming and remaining current on their debt payments, lowering the amount they are borrowing relative to their

available credit, and reviewing their credit reports for errors that may have lowered their rating.

b. If we were to take all of the toxic assets off of the balance sheets of our banks, would one expect a dramatic improvement in credit markets?

The removal of toxic assets from bank balance sheets would contribute to some improvement in credit markets. The extent of the improvement under such a scenario is difficult to forecast, however. If market participants were convinced about the better health of banks, this would show up as a narrower spread between the rates they charge each other for funds versus the rate the Federal Reserve targets for monetary policy. Federal Reserve Chairman Bernanke has discussed this interest rate spread as being a key indicator measuring the improvement in credit markets.

(5) "Federal Reserve Balance Sheet"

The Federal Reserve balance sheet has grown. Is there a limit to this expansion? Does there come a point where the Fed becomes overextended?

From a financing standpoint, there are few limits to the expansion of the Federal Reserve balance sheet. When the Federal Reserve wanted to expand its balance sheet in September 2008, it asked the Treasury to borrow funds from the public and deposit them with the Fed. After the passage of Emergency Economic Stabilization Act (EESA), the need for the Treasury to be an intermediary was no longer necessary, because the EESA permitted the Fed to pay interest on bank reserves held by the Fed. That lead to a substantial increase in reserves, which provided the Fed with a funding source for expanding the balance sheet. By adjusting the interest rate it pays on those reserves, the Fed has a greater amount of flexibility to adjust the size of its balance sheet. Currently, the interest rate that the Fed pays on reserves is 0.25 percent, at the upper end of the Fed's target range of 0 percent to 0.25 percent.

However, the Fed may face a constraint if it reaches a point at which it cannot attract enough reserves at current levels of interest rates. Such a situation could occur if increased debt issuance by the Treasury causes short-term Treasury rates to rise above the federal funds rate. Since market participants deem Treasury bills to be a near perfect substitute for placing funds with the Fed, this scenario would create difficulties for the Fed. If this situation were to occur, the Fed could raise its target for the federal funds rate in line with Treasury bills in order to attract the needed amount of excess reserves. Alternatively, if the Fed did not want to raise the federal funds rate, it could obtain funds directly from the Treasury to fund its balance sheet or issue its own longer-term debt (which carries a higher interest rate than short-term debt). (New legislation would be required to allow the Fed to issue its own debt.)

Some analysts are concerned that a more important limit the Fed faces on its balance sheet may be the potential conflict between its goals of price stability and financial stability. If the Fed's balance sheet were to remain at a substantially higher than its pre-crisis level for an extended time, particularly as the economy recovers, concerns among market participants over inflation risks could be an effective constraint on the balance sheet.

When the time comes for the Fed to tighten monetary policy, it will have to reduce the size of the balance sheet. This is uncharted territory for the Fed (and central banking in general), which raises the risks of making a policy mistake – either by reducing the size too slowly or too rapidly. Those risks may be quite large currently given the unusually large size of the balance sheet, and may contribute to volatility in financial markets until markets understand the Fed's success in reducing the balance sheet.

(6) "Consequences of Rising Federal Debt"

Can you speak to the broad economic consequences we face if there isn't a commitment by the federal government to reduce our debt moving forward? How might the competiveness of U.S. businesses and the lives of average American families be impacted?

Under current recessionary conditions, debt-financed increases in government spending, or decreases in taxes, can help boost the economy by raising aggregate demand. However, in the long run increases in government debt may reduce economic output by crowding out investment in productive capital. In addition, higher levels of debt imply higher interest payments that must be financed in future budgets.

In the long run, the potential output of the economy is determined by the stock of productive capital, the supply of labor, and productivity. Increases in government debt tend to reduce the stock of productive capital because people who purchase the debt end up holding more of their savings as government bonds rather than in a form that can be used to finance private investment. In economic parlance, the debt will "crowd out" private investment. To the extent that private saving or capital inflows rise in response to the increase in debt, the negative effect on investment is reduced. However, while capital inflows help to maintain investment, they do not necessarily improve living standards in the long run because they obligate the nation to pay a greater net amount of interest and profits to foreigners.

The effect of government debt on output may also be offset by other factors. Debt may be issued to finance productive government investments, such as well-planned highway projects, which can add to the economy's potential output in much the same way the private capital investment does. Other government expenditures, such as grants to increase access to college education, could raise long-term productivity by enhancing people's skills. And tax policies such as reductions in marginal rates on labor or capital income can increase incentives to work and save.

Debt issued to acquire financial assets may also have limited economic effects. For example, under the Troubled Assets Relief Program (TARP) the Secretary of the Treasury was authorized to purchase up to $700 billion of a wide variety of financial instruments, with the purchases financed by issuance of additional debt. However, the government would be able to recoup some portion of that amount by eventually selling the assets. CBO concluded that the net cost of the program – and therefore the long-run effect on federal debt - was likely to be substantially less than $700 billion, but more likely than not to be greater than zero.

CBO has evaluated the economic effects of the increased debt generated by the American Recovery and Reinvestment Act (ARRA), including the offsetting effects described above. CBO concluded that ARRA, which is estimated to increase budget deficits by a total of $787 billion over the 2009-2019 period (not including interest costs or budgetary reflows from its economic effects) would reduce the level of output by between zero and 0.2 percent by 2019.

In addition to those direct effects on output, increased debt implies higher government interest payments that must be offset by other policy changes at some point. Sooner or later, taxes must be higher or government spending lower than it would have been otherwise in order to finance the increased interest. To the extent that such financing was accomplished through distortionary taxes there could be additional negative effects on output in the long run.

THE GLOBAL ECONOMY: OUTLOOK, RISKS, AND IMPLICATIONS FOR POLICY

THURSDAY, JANUARY 29, 2009

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

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

Present: Senators Conrad, Nelson, Stabenow, Sanders, Whitehouse, Warner, Merkley, Gregg, Graham, and Alexander.

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

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order. I want to welcome everyone to the Budget Committee this morning. Today's hearing is titled "The Global Economy: Outlook, Risks, and Implications for Policy."

We have a very distinguished group of witnesses this morning. They are Dr. Simon Johnson, who was formerly the Chief Economist at the International Monetary Fund and is now a Professor of Entrepreneurship at MIT Sloan School of Management, and a Senior Fellow at the Peterson Institute for International Economics. Dr. Johnson testified before our Committee in November, and we are very pleased that he is back with us again today. Dr. Brad Setser, a Fellow for Geoeconomics at the Council on Foreign Relations. And Tim Adams, who was formerly the Under Secretary for International Affairs at the Treasury Department and now is a Managing Director of the Lindsey Group. Welcome to you all. I am delighted to have you before the Committee this morning.

Let me begin by providing a brief overview of the problem that we now confront. The first thing I was handed as I walked in this morning was this article—today's Financial Times—entitled "Economic pain to be 'worst for 60 years,'" a warning that 50 million people could lose their jobs globally. That is a pretty sobering story.

I think all of us know we are in the worst economic downturn our country has seen since the Great Depression. We have lost nearly 2 million jobs in the last 4 months.

FINANCIAL TIMES

888 Thursday January 29 2009

Economic pain to be 'worst for 60 years'

Warning that 50m people could lose jobs

House passes $819bn fiscal stimulus plan

By Krishna Guha and Alan Beattie in Washington and Chris Giles in Davos

The world economy will this year suffer its worst performance for more than 60 years, with a serious risk that 50m people will lose their jobs, international organisations warned yesterday.

The warnings came as the House of Representatives passed an $819bn version of the fiscal stimulus plan, and the Federal Reserve expressed fresh concern about deflation. The Fed said the US economy had "weakened further" since its last policy meeting in December.

The US central bank made no immediate move to purchase Treasury securities – disappointing some in the markets. The yield on 10-year Treasuries rose 14 basis points to 2.965 per cent.

Earlier, the International Monetary Fund increased its estimate of credit losses on US-based assets from $1,400bn to $2,200bn. It also said world output, measured at market exchange rates, would fall in 2009 for the first time since the second world war. Weighted by purchasing power, growth would be very slightly positive.

The new growth forecasts mark a huge revision – down by more than 1.5 percentage points – from the IMF's previous forecast for the year in spite of the inclusion of the fiscal stimulus efforts by governments into its predictions for the first time. Advanced economies, the IMF predicted, would contract 2 per cent in 2009, with the UK hit hardest.

In Geneva, the International Labour Organisation said the global recession would lead to a "dramatic increase" in unemployment this year, which would certainly lead to 18m-30m additional unemployed and more than 50m "if the situation continues to deteriorate".

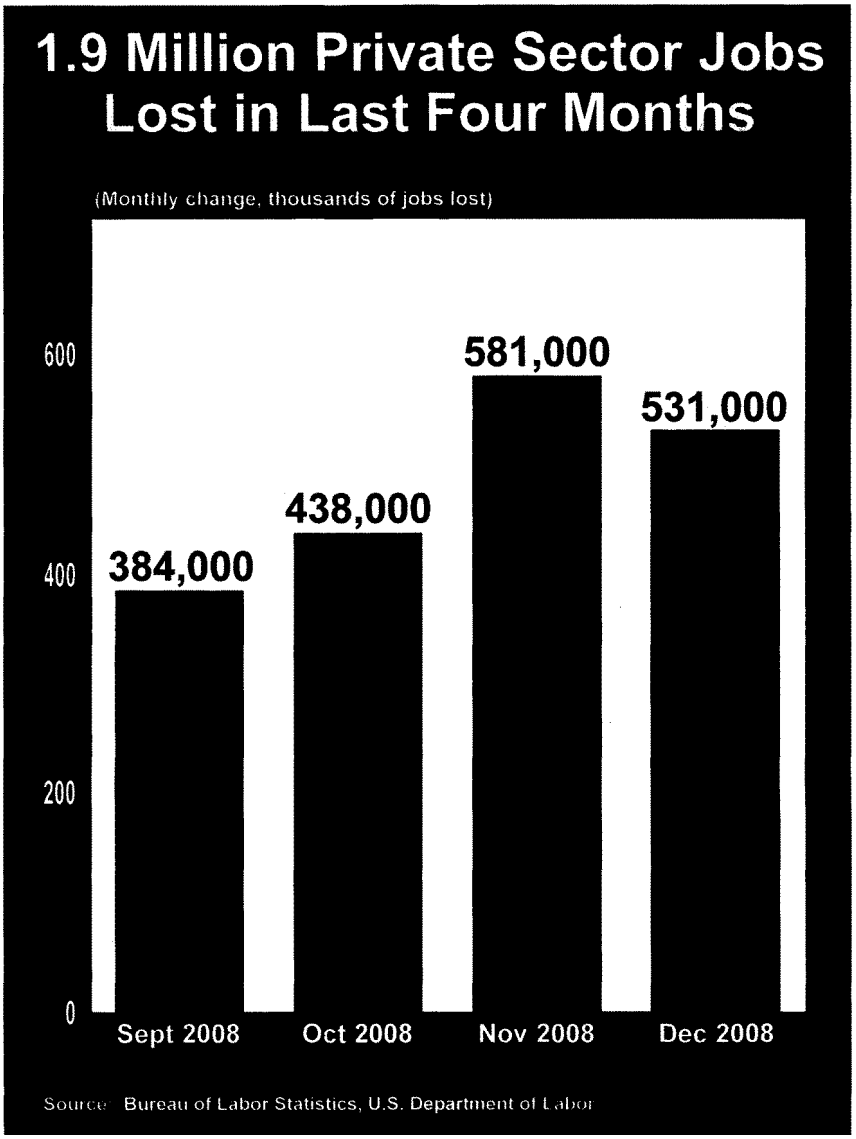
The forecasts helped frame a sombre mood as executives and policymakers started the annual meeting of the World Economic Forum in Davos, with leaders stressing the sharp and synchronised nature of the downturn, expressing concern about global policy coordination and some scepticism that fiscal interventions would ensure a recovery.

President Barack Obama, meanwhile, hosted a meeting with US corporate leaders to rally support for the fiscal stimulus plan amid resistance from Republicans opposed to massive government spending, who voted unanimously against the bill in the House.

The Fed said it was prepared to buy long-term Treasury securities if circumstances suggested this would be effective in bringing down borrowing costs for households and businesses. But it signalled its inclination was to fight economic risks with more targeted credit programmes, and possibly further acquisition of securities issued by Fannie Mae and Freddie Mac.

Analysts appeared confused as to whether the statement brought the Fed closer to actually buying Treasuries.

World in recession, Page 2 and 3
George Soros, Page 5
www.ft.com/usdailyview

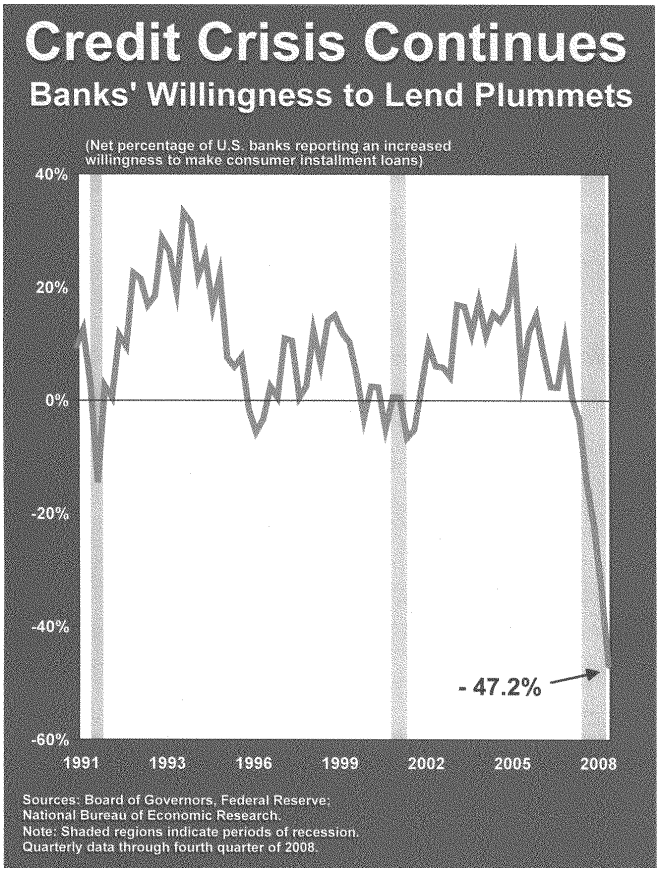


The housing crisis that has been central to the downturn is continuing. One in every five mortgages is underwater. Some even assert one in every four homes is underwater, meaning the home is worth less than the remaining balance on the mortgage. And one out of every ten mortgages is either in default or delinquent.

Housing Crisis Continues

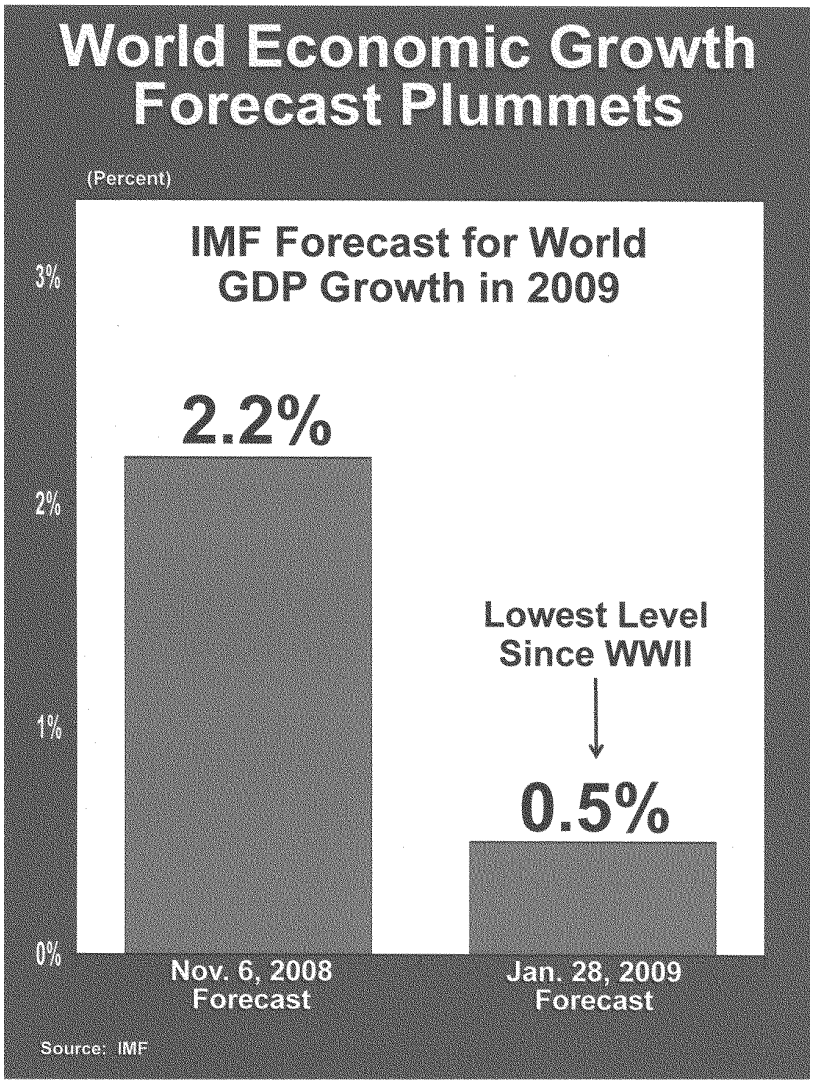
- One out of five mortgages is "underwater" – with home worth less than remaining balance
- One out of ten mortgages is delinquent or in foreclosure

And the financial market crisis that resulted from the housing crisis is also continuing. Credit remains very much locked up, although it has improved in some ways from what we saw in November. This chart shows that about half of U.S. banks indicated they became less willing to make consumer installment loans in the final months of last year.



We also saw in the press this morning a review of commercial real estate, tens of billions of dollars just in this area that is going to come due over the next 5 years because it was financed initially at a time of record refinancings and initial financings that were done through mortgage securitizations. And the question is: How are those properties going to get extended in terms of their financing?

As the title of this hearing suggests, this is also a global economic crisis. It is not limited to our shores. In just the last 3 months, the IMF's forecast for world GDP growth has fallen from 2.2 percent to a half of 1 percent, and I believe that is overly optimistic.



That represents the lowest level of worldwide economic growth since World War II. The downturn has been spreading from country to country and is getting worse.

Here was the headline in the Washington Post last weekend: "Downturn accelerates as it circles the globe. Economies worse off than predicted just weeks ago."

The Washington Post
Saturday, January 24, 2009

Downturn Accelerates As It Circles The Globe

Economies Worse Off Than Predicted Just Weeks Ago

By Anthony Faiola
Washington Post Staff Writer

The world economy is deteriorating more quickly than leading economists predicted only weeks ago, with Britain yesterday becoming the latest nation to surprise analysts with the depth of its economic pain.

Britain posted its worst quarterly contraction since 1980 on the heels of sharper than expected slowdowns reported from Germany to China to South Korea. The grim data, analysts said, underscores how the burst of the biggest credit bubble in history is seeping into the real economies around the world, silencing construction cranes, bankrupting businesses and throwing millions of people out of work.

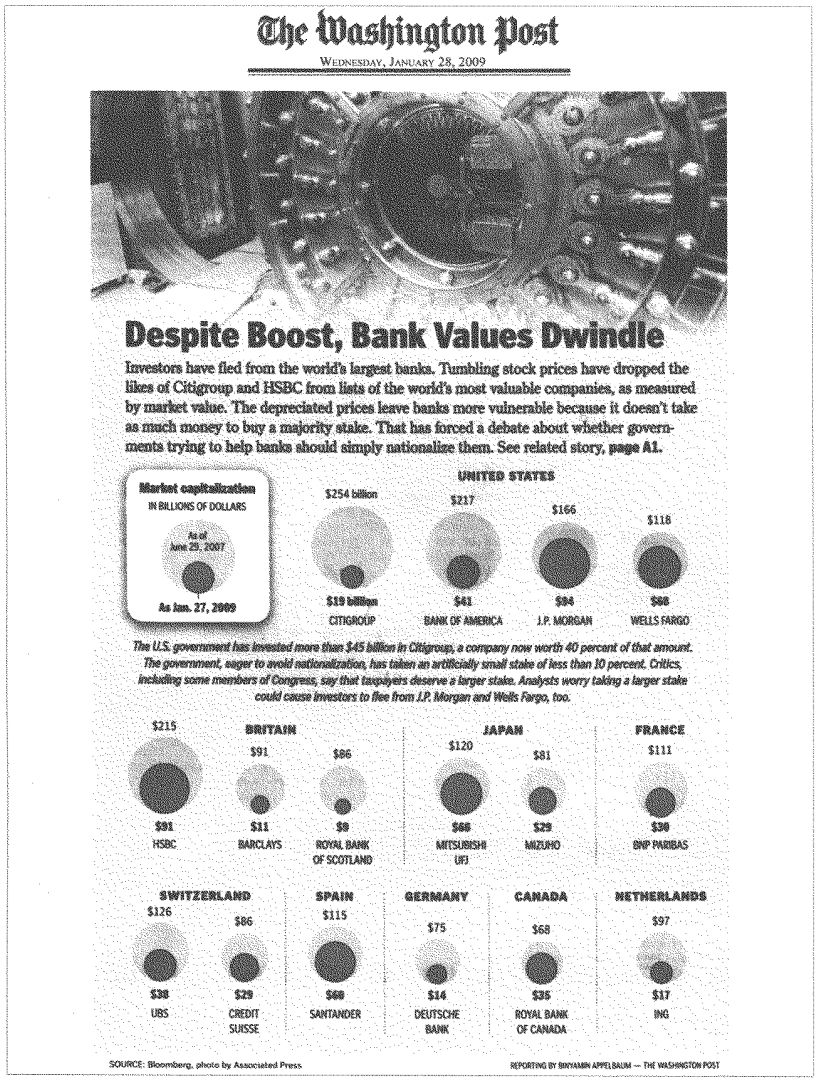
"In just the past few days, we've had a big downward revision, we're seeing that an even bigger deceleration is on the way than we thought," said Simon Johnson, former chief economist at the International Monetary Fund and a senior fellow at the Peterson Institute for International Economics.

The depth of the troubles, analysts say, indicates that nations may need to spend more than the billions of dollars already planned on stimulus packages to jump-start their economies, and that a global recovery could take longer, perhaps pushing into 2010.

Analysts are particularly concerned about the slowdown in China and the recession in Europe. There is mounting concern about the stability of the euro and the British pound, which dropped to a 24-year low against the dollar yesterday. Analysts are fretting about the possibil-

See ECONOMY, *Page A4*

The world's biggest and traditionally most stable financial institutions have been rocked by this crisis. This graphic in the Washington Post yesterday depicted the dramatic decline in value of leading banks throughout the world.



The Washington Post

WEDNESDAY, JANUARY 28, 2009

Despite Boost, Bank Values Dwindle

Investors have fled from the world's largest banks. Tumbling stock prices have dropped the likes of Citigroup and HSBC from lists of the world's most valuable companies, as measured by market value. The depreciated prices leave banks more vulnerable because it doesn't take as much money to buy a majority stake. That has forced a debate about whether governments trying to help banks should simply nationalize them. See related story, page A1.

The U.S. government has invested more than $45 billion in Citigroup, a company now worth 40 percent of that amount. The government, eager to avoid nationalization, has taken an artificially small stake of less than 10 percent. Critics, including some members of Congress, say that taxpayers deserve a larger stake. Analysts worry taking a larger stake could cause investors to flee from J.P. Morgan and Wells Fargo, too.

SOURCE: Bloomberg, photo by Associated Press

REPORTING BY BINYAMIN APPELBAUM — THE WASHINGTON POST

The loss in global wealth represented by these numbers is simply stunning. I look forward to hearing from our witnesses today on the implications of this global meltdown and how it should impact our policy decisions here.

I believe the key to our recovery will be our ability to address the housing and financial market crises as well as giving lift in the short term to our domestic economy. The recovery package now being considered I do not believe will be as effective as it needs to be if we do not address those underlying problems. And the great concern that I have, as I look at this package coming over from the house—and I couple it with what is available in the TARP fund—I am very concerned that we are insufficiently addressing the hous-

ing downturn and the continuing lockdown in our credit markets. So I believe we have all got to bend our best efforts to improving this package.

I have no doubt, none at all, that a recovery package is necessary, and a large recovery package is necessary. At the same time, I believe it does need to meet the three tests of timely, temporary, and targeted. And I believe it is absolutely imperative that we make certain that these investments that are made provide the biggest bang for the buck possible.

I think there are elements of the House package that just do not meet that test. And I am also most concerned that we are going to find 4 months from now the administration coming back to us and asking for hundreds of billions of dollars more to deal with the financial institutions of the country.

So that is a focus I want to put on this hearing today and ask these distinguished witnesses to address as we get to the questioning period.

With that, I would turn to Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman. Thank you once again for your excellent outline of the issue, and I, as you know, agree 100 percent with your assessment that the present stimulus package is not on target. The problem is real estate. We need to fix the problem now, and we need to put value into the real estate markets, which will give homeowners confidence that their asset is worth what they paid for it, or a reasonable amount, and that they can afford the mortgages which they are paying on it, and, equally important, that the lenders' value of these assets is able to be stabilized so that they can assess where they stand relative to their capital situations, which is one of the big problems.

So the problem is real estate. This is the nail we should be hitting, and yet we appear to be taking the hammer and moving over and trying to hit some other nails, which are significant but are not necessarily that relevant to the immediate problem.

So I would hope we could rewrite the stimulus package, and I would hope we could do it in a positive and bipartisan way by moving some of the funds that are going to go into the long-term baseline for the purposes of programmatic activity that should be undertaken in the usual appropriation process, and moving those dollars now over and onto the issue of addressing the real estate issue. And then if they are in the appropriations process, if those committees wish to—within your budget, of course, limitations—address those priorities, they will be able to.

On the international front, I would be interested to hear from the panel today, because my sense is that this is—we are not going to get out of this slowdown through international efforts, that basically the ability to turn this around is going to require that America basically proceed in a coherent and thoughtful way, hopefully in conjunction with our trading partners. But as a very practical matter, we are the most cogent entity and we are the biggest economy, and, therefore, we have the responsibility to move forward.

But I am going to be interested to hear what our excellent panel has to say on the issue of where these other economies are going.

What is happening in Japan, what is happening in China, and, obviously, what is happening in the European Community is very important to us. And so I thank you for convening this excellent panel of talented individuals, and I look forward to hearing their comments.

Thank you.

Chairman CONRAD. Thank you, Senator Gregg, and we will begin with Dr. Johnson. Again, welcome back. We are delighted you are here. Please proceed.

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

Mr. JOHNSON. Thank you very much, Senator Conrad.

Let me start by making three brief remarks about the global economic situation and then go on to talk about policy implications for the United States. I think both you and Senator Gregg nicely outlined some of the very pressing dilemmas before us.

But to begin with the global situation, let me say something about what is happening in Europe, particularly in the euro zone, something about emerging markets, and something about what seems to be happening to global savings or attempted savings around the world.

The first point I would like to make about the euro zone and Europe is that while we are quite justifiably focused on the financial dimensions of the crisis in the United States—and we are very worried about real estate and about banking, obviously—these issues exist in Europe, but it has become a much deeper problem for many sovereigns there, for many countries, because it has become a fiscal issue. And this is for several reasons that we can talk about further later in the session if you are interested.

The basic point is that these European countries started out with a lot more debt to GDP than did the United States. Let me just take Greece as an example—not to pick on Greece. There are other countries in a similar category. But Greece had a debt to GDP at the beginning of this crisis around 90 percent. Now, Greece is going to have to undertake some financial bailout. It is going to suffer a loss of revenue through the recession, and it is pushing its debt level into an area where the financial markets regard the possibility of default or missing payments by Greece to be a significant probability. And that affects not only Greece; it affects other relatively weak euro zone sovereigns. Portugal, Ireland, Italy, Greece, and Spain are all considered to be more or less in the same boat.

Now, there are related problems in East-Central Europe that we can expand on. I think most of the countries there are going to require some form of IMF assistance before we are done with this situation. I think the programs and the program structure that has been adopted for East-Central Europe is not ideal and may cause further problems down the road.

Of course, the financial entities with the greatest exposure to East-Central Europe are West European banks. Austria has a very large banking presence in Eastern Europe; so does Sweden and so does Greece.

The problems in Europe are not confined to the euro zone. Similar problems apply also in the United Kingdom where we are expecting a very rapid deceleration in growth. There is a large financial sector relative to GDP, and the ability of the government to manage its way through this process without nationalizing the banks and without taking on a great deal of responsibility, which they cannot afford that possibility, remains very much on the minds of the financial markets. It is one reason why the pound continues to weaken and U.K. interest rates continue to rise.

So that is the problem in Europe and the euro zone. It is a fiscal problem. The financial crisis has become a fiscal issue in Europe. If you like to think of it in these terms, you could say that is what we must avoid at all costs in the United States. We have to maintain fiscal integrity so that people do not worry about the AAA credit rating in the U.S., as they are beginning to worry, for example, in the United Kingdom.

I think these euro zone problems are—we talked about them a little bit in November when I appeared before this Committee, but they perhaps were not completely evident. I think now there is more agreement that these problems are developing fast and 2009 is going to be a very difficult year for Europe. And this is reflected to some degree in the marking down of the official growth forecasts, for example, from the IMF yesterday. I still think those forecasts are rather on the high side, personally.

The second set of global issues around emerging markets, here I think there is still a lack of realization of the severity of the problems. It is very difficult for any emerging market government to roll over its debt right now. They are all suffering a severe, rapid drop in their exports. The figures, the projections for international trade, which have been provided by the World Bank a little while ago and by the IMF yesterday, I think are definitely on the optimistic side. We are seeing a fall in both the exports of manufacturers and in the exports and prices for commodities. And this is going to affect, again, most emerging markets partly through their financial systems but, again, through their fiscal systems.

And my third point is that this adds up to a global pattern with regard to spending and savings around the world. I think that while there have been—and this speaks to a point in the question raised by Senator Gregg a moment ago. There have been calls for a global fiscal stimulus and for other countries to join the United States in trying to sustain the global economy through a large discretionary fiscal package of 2 percent of GDP, is actually the call from the IMF.

I think that is really—whether or not it is a good idea, it is not going to happen. I think the fiscal position of almost all countries in the world is sufficiently difficult that they will not be able to come through with that kind of fiscal expansion. In fact, I think many of the countries, including the ones I just mentioned, will be looking at some form of fiscal austerity in order to reassure the financial markets that their government debt is going to be fine and that they should not be worried about potential sovereign default.

The one exception, of course, is China. China does have room, longstanding room for fiscal stimulus, and I think they will do something substantially less than the headline numbers suggest,

probably on the order of 2 to 3 percent of GDP per annum for the next couple of years. That is a significant fiscal stimulus. It is helpful for the Chinese economy. I do not think you will notice it at the global level. China is about 6 percent of the world economy at market exchange rates, so we are talking about 3 percent or 6 percent. That is the rounding error in the measurement of world GDP.

So in terms of a global approach, it will not come, I think, through the fiscal side, and if anything, we are going to be hard pressed because most countries want to cut back and most people, including households and corporates in most countries, want to cut back. And most governments outside the United States also want to cut back. So what we are seeing is a big move toward attempted increased savings, which is distinctly reminiscent of what happened in Japan during the 1990's.

In Japan, during that decade, most of the private sector tried to increase its savings. There was a big slowdown. The government, of course, tried repeated fiscal stimulus without, at least initially, addressing the problems of the banking system and without addressing the problems in the real estate sector. And that was not very successful.

The saving grace in Japan, of course, during the 1990's was they could export, so their export sector remained quite strong. That is not an option for the world as a whole, obviously. And I think we are facing quite seriously the prospect of a lost decade at the global level. The private sector, I would say, sees the recession as something of a U-shape, with the recovery occurring at some point in 2010. The official sector, including the IMF and the World Bank, are still with more of a V-shape, so a fairly rapid recovery beginning in the second half of 2009.

I would submit to you that it is much more likely to be an L-shape, so we go down a considerable distance, and then we really struggle to recover. There may be moments of incipient recovery. Japan had several in the 1990's. But they never really took hold, at least until they cleaned up their financial system. And I think it is the combination, I would stress, of a fiscal stimulus and sufficiently dramatic and comprehensive action to really recapitalize the banking system and remove in some form—and we could discuss the various reasonable possibilities—remove in some form the toxic assets from the banks' balance sheets, or at least remove them from the concern facing new investors in those banks.

But I would also in closing like to pick up on Senator Gregg's point. I do completely agree that while we are addressing—while we are providing fiscal stimulus and addressing the financial system, we must not lose sight of housing. And I think there are some very sensible ideas out there in terms of refinancing packages that would reduce the risk of mortgage foreclosure and also try and break this death spiral of foreclosure, forced sales, lower house prices, leading to more foreclosures. There is no question at all that unless and until we get our hands on that fundamental, we are going to face substantial downside risks.

Thank you very much.

[The prepared statement of Mr. Johnson follows:]

Testimony to the Senate Budget Committee hearing on *The Global Economy: Outlook, Risks, and the Implications for Policy*, January 29, 2009. (Embargoed until noon)

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com (a widely cited source for daily policy analysis on the global crisis.)

Summary

1) The world is heading into a severe slump, with declining output in the near term and no clear turnaround in sight. We forecast a contraction of minus 1 percent in the world economy in 2009 (on a Q4-to-Q4 basis), making this by far the worst year for the global economy since the Great Depression. We further project no recovery on the horizon, so worldwide 2010 will be "flat" relative to 2009.
2) Consumers in the US and the nonfinancial corporate sector everywhere are trying to "rebuild their balance sheets," which means they want to save more and spend less.
3) Governments have only a limited ability to offset this increase in desired private sector savings through dissaving (i.e., increased budget deficits that result from fiscal stimulus). Even the most prudent governments in industrialized countries did not run sufficiently countercyclical fiscal policy during the boom and now face balance sheet constraints.
4) Compounding these problems is a serious test for the Eurozone: financial market pressure on Greece, Ireland and Italy is mounting; Portugal and Spain are also likely to be affected. The global financial sector weakness has become a potential fiscal issue of the first order in these countries. This will lead to another round of bailouts in Europe, this time for weaker sovereigns in the Eurozone. As a result, fiscal policy will be even less countercyclical, i.e., governments will feel the need to attempt precautionary austerity, which amounts to a further increase in savings.
5) At the same time, the situation in emerging markets is moving sharply towards near-crisis, particularly as global trade contracts and there are immediate effects on both corporates and the financial system. Currency collapse and debt default will be averted only by fiscal austerity. The current IMF strategy – most clearly evident in East-Central Europe – is to protect creditors fully with programs that do not allow for nominal exchange rate depreciation. This approach increases the degree of contraction and social costs faced by domestic residents, while also making economic recovery more difficult. These programs will likely prove more unpopular and less successful than were similar programs in Latin America in the 1980s and in Asia in the 1990s. As East-Central Europe slips into deeper recession, there are severe negative consequences for West European banks with a high exposure to the region (including Austria, Sweden and Greece).
6) The global situation is analogous to the problem of Japan in the 1990s, in which corporates attempted to repair their balance sheets while consumers continued to save as before and fiscal stimulus repeatedly proved insufficient. The difference, of course, is that exports were able to grow and Japan could run a current account surplus; this does not work at a global level. Global growth prospects are therefore no better than for Japan in the 1990s.
7) A rapid return to growth requires more expansionary monetary policy, and in all likelihood this needs to be led by the United States. But the Federal Reserve is still some distance from fully recognizing deflation and, by the time it takes that view and can implement appropriate actions, declining wages and prices will be built into expectations, thus making it much harder to stabilize the housing market and restart growth. The European Central Bank still

fails to recognize the seriousness of the economic situation. The Bank of England is embarked on a full-fledged anti-deflation policy, but economic prospects in the UK still remain dire.

8) The push to re-regulate, which is the focus of the G20 intergovernmental process (with the next summit set for April 2), could lead to a potentially dangerous procyclical set of policies that can exacerbate the downturn and prolong the recovery. There is currently nothing on the G20 agenda that will help slow the global decline and start a recovery. The Obama Administration will have a hard time bringing its G20 partners to a more pro-recovery policy stance.
9) The most likely outcome is not a V-shaped recovery (which is the current official consensus) or a U-shaped recovery (which is closer to the private sector consensus), but rather an L, in which there is a steep fall and then a struggle to recover. A "lost decade" for the world economy is quite possible. There will be some episodes of incipient recovery, as there were in Japan during the 1990s, but this will prove very hard to sustain.

Background

The current official consensus view (e.g., as seen in the World Bank's Global Economic Prospects, the OECD's leading indicators, or the latest IMF World Economic Outlook) is that we are having a serious downturn, with annualized growth for the fourth quarter in the US at around minus 5%. But the consensus is that a recovery will be underway by late-2009 in the US and shortly thereafter in the Eurozone. This will help bring up growth in emerging markets and developing countries, so by 2010 global growth will be moving back towards its 2006-2007 rates.

Our baseline view is considerably more negative. While we agree that a rapid fall is underway and the speed of this is unusual, we do not yet see the mechanisms through which a turnaround occurs. In fact, in our baseline view, there is considerably more decline in global output already in the works and, once the situation stabilizes, it is hard to see how a recovery can easily be sustained.

The consensus view focuses on disruptions to the supply of credit and recognizes official attempts to support this supply. In contrast, we emphasize that the crisis of confidence from mid-September has now had profound effects on the demand for credit and its counterpart, desired savings, everywhere in the world.

To explain our position, we first briefly review the background to today's situation. (Readers who would like more detail on what happened in and since mid-September should refer to the November 10 edition of our baseline scenario.) We then review both the current situation and the likely prognosis for policy in major economies and for key categories of countries. While a great deal remains uncertain about economic outcomes, after the US presidential election much of the likely policy mix around the world has become clearer. We conclude by reviewing the prospects for sustained growth and linking the likely vulnerabilities to structural weaknesses in the global system, including both the role played by the financial sector almost everywhere and the way in which countries' financial sectors interact. In the end we come full circle - tomorrow's dangers can be linked directly back to the underlying causes of today's crisis.

Understanding the Crisis

The precipitating cause of today's global recession was a severe "credit crisis," but one that is frequently misunderstood in several ways.

1. While the US housing bubble played a role in the formation of the crisis and continued housing problems remain an issue, the boom was and the bust is much broader. This was a synchronized debt-financed global boom, facilitated by flows of capital around the world.
2. In particular, while the US boom was at the epicenter of the crisis, regulated European financial institutions played a critical role in facilitating the boom and spreading the adverse consequences worldwide. And, like the US, some European governments ran relatively irresponsible fiscal policies during the boom, making them now unable to bail out their financial systems without creating concerns about sovereign solvency.
3. The boom exacerbated financial system vulnerability everywhere. But the crisis in the current form was not inevitable. The severity of today's crisis is a direct result of the failure to bail out Lehman and the way in which AIG was "saved" - so that senior creditors took large losses and confidence in the credit system was shaken much more broadly.
4. The initial problem, from mid-September 2008, was a fall in the supply of credit. But this does not mean that the current and likely pending official support for credit supply will turn the situation around. Now the crisis has affected the demand side - people and firms want to pay down their debts and increase their precautionary savings.
5. There is no "right" level of debt, so we don't know where "deleveraging" (i.e., the fall in demand for and supply of credit) will end. Debt could stabilize where we are now or it could be much lower. Leverage levels are very hard for policy to affect directly, as they result from millions of decentralized decisions about how much people borrow. Anyone with high levels of debt in any market economy is now re-evaluating how much debt is reasonable for the medium-term.
6. As a result, while attempts to clean up the US and European financial systems make sense – and are needed to support any eventual recovery – this will not immediately stop the process of financial contraction and economic decline.
7. Fiscal stimulus, similarly, can soften the blow of the recession, but will not directly address the underlying problems. And many countries already face binding constraints on what their governments can do in this regard.
8. A dramatic shift in the stance of monetary policy is required in almost all industrialized countries and emerging markets. Unfortunately, the need for this shift is not currently recognized by official orthodoxy and it is not yet clear when this will change.

The Global Situation Today

Western Europe

Major Western European countries, beginning with the UK, have been severely affected by the global recession. The composite of forecasts tracked by Bloomberg predicts a contraction of 3% in GDP not only for the UK, whose housing bubble and degree of dependence on the financial sector were arguably greater than in the US, but even in Germany, whose exports are under severe pressure; their cars, machinery, and similar durables have a great reputation, but how

many of them do customers really need to buy this quarter? The Eurozone as a whole is expected to contract by over 2%.

In the UK, the prospect of further bank nationalization now looms. The UK is a AAA-rated sovereign with its housing market in a nose dive, overextended (and apparently mismanaged) major banks, and a government on its way to guaranteeing all financial liabilities and directing the flow of credit moving forward. The emerging strategy is based more on depreciating the pound - which is contributing to tensions with other European countries - and surprising people with inflation than on fully-funded bank recapitalization. Additional fiscal stimulus increasingly looks irrelevant and perhaps even destabilizing. The yield on 10-year government bonds is, of course rising - now over 3.5%.

Pressures on individual governments are even greater in some parts of the Eurozone, where individual countries do not have control over monetary policy. Greece faces the most immediate problems, as demonstrated both by widening credit default swap spreads and increasing spreads of Greek bonds over German government bonds. The cost of servicing Greek government debt is thus rising at the same time as Greece has to roll over debt worth around 20 percent of GDP in the coming year. Greece has a debt-to-GDP ratio that is close to 100 percent, so there is real risk of default. Recognizing that credit ratings are a lagging but not meaningless indicator, Greece's downgrade was not unexpected, but Spain's downgrade from AAA is a significant milestone. Further European downgrades are in the air.

What do all these situations have in common? Markets are repricing the risk (or coming to their senses) on the dangers of lending to a wide range of governments. And this is not just about emerging markets (East-Central Europe) or industrialized countries that sustained a boom based on euro convergence (Portugal, Ireland, Italy, Greece and Spain are now known collectively in the financial markets as the PIIGS). The markets are potentially rethinking the risk of any government's obligations.

The reaction that one hears from senior European officials and richer Eurozone countries is that Greece (and Spain and Italy and others) should deal with their fiscal problems themselves. There is very little sympathy. However, we expect that in the end Greece will receive a bailout from other Eurozone countries (and probably from the EU). This, however, does not come early enough to prevent problems from spreading to Ireland and other smaller countries (which then also need to implement fiscal austerity or to receive support). Italy is also likely to come under pressure, due to its high debt levels, and here there will be no way other than austerity. With or without a bailout, Greece and other weaker euro sovereigns will need to implement fiscal austerity. The net result is less fiscal stimulus than would otherwise be possible, and in fact there is a move to austerity among stronger euro sovereigns as a signal. Governments will therefore struggle to dissave enough to offset the increase in private sector savings.

What are the implications for German debt? There is no question that Germany will do whatever it takes to maintain a reputation for fiscal prudence. Despite the severe downturn, the German government recently struggled to pass a stimulus package of only 2.5% of GDP over two years, and the pressure now is to balance the budget. But problems in the Eurozone are putting pressure on the European Central Bank (ECB) to loosen its policies (and there are murmurs

already about easing repo-rules as credit ratings fall - basically, supporting euro sovereigns during their downward spiral), and this has implications for currency risk. Despite the pressure to relax monetary policy, the ECB will continue to be slow to respond. The ECB's decision-making process seeks consensus and some key members are still more worried about inflation down the road than deflation today. The ECB's benchmark rate is still at 2%. Eventually the ECB will catch up, but not before there has been considerable further slowing in the Eurozone.

The current consensus forecast is that the Eurozone will start to recover in mid-2009 and be well on its way to achieving potential growth rates again by early 2010. This seems quite implausible as a baseline view.

Japan

The yen has appreciated as carry trades have unwound, so people no longer borrow in yen to invest elsewhere. This, in addition to the global recession, has had a crippling effect on exports, which fell by 35% from December 2007 to December 2008. Corporates are likely to want to strengthen their balance sheets further and households with already-high savings rates are unlikely to go on a spending spree. As a result of these factors, the Bank of Japan recently predicted that the country will suffer two years of economic contraction and deflation.

The government's balance sheet is weak, but it is funded domestically (in yen, willingly bought by households), so there is room for further fiscal expansion. However, this is unlikely to come quickly.

The ability of the Japanese central bank to create inflation has proved limited. Once deflationary expectations are established, these are hard to break. In the inflation swap market, the average annual rate of inflation expected over five years is minus 2.4%, and an astonishing minus 1.0% over 30 years. This difficulty in creating positive inflation expectations will make it harder for any fiscal stimulus to be successful in restarting the economy.

China

The current crisis has shown that China's economy is far from invulnerable. The 6.8% year-over-year growth rate in Q4 may have implied that the quarter-over-quarter growth rate was around zero, and forecasts for 2009 are in the 6-8% range - below the level commonly understood as the minimum to avoid growth in unemployment.

The major increase in savings by China over the past 10 years was primarily due to high profits in the corporate sector. Chinese growth now seems likely to slow sharply, and this will likely reduce savings and the current account. China still does have long-standing scope for a fiscal stimulus. But the Chinese economy is only about 6% of world GDP and their effective additional stimulus per year is likely to be around 3% of GDP. 3% of 6% is essentially a rounding error in the world's economy, and will have little noticeable effect globally - although it might just keep oil prices higher than they would be otherwise.

India

There are striking similarities between the current policy debate in India and in the Eurozone. In both places, there is little or no concern that inflation will rebound any time soon. At least for people based in Delhi, there is as a result confidence that aggressive monetary policy can cushion the blows coming from the global economy. As in the Eurozone, all eyes are on monetary policy because of fears that fiscal policy cannot do much more than it is already doing, given that government debt levels are already on the high side.

The discordant note comes from the business community. They feel that Delhi does not fully understand that the real economy is already in bad shape. Sectors such as real estate and autos are hurting badly. Small businesses, in particular, are bearing the brunt of the blow. The banking picture seems more murky, but is surely not good. And of course the Satyam accounting scandal could not come at a worse time.

Overall, official growth forecasts need to be marked down for India, although the monsoon was good and the agricultural sector is not highly leveraged. India will likely cut interest rates further quite soon (and has space for additional cuts), but we should not expect much more from the fiscal side.

East-Central Europe

Pressure on other emerging markets continues to intensify. East-Central Europe (including Turkey), which spent the last several years borrowing heavily from Western European banks, has been especially hard hit by the contraction of credit as those banks turn to hoarding cash. The IMF is projecting contraction for both East-Central Europe and Russia; in the latter case, this is a Corporates and governments have major debt rollover problems, and most of the region is a severe turnaround from estimated growth of 6.2% in 2008.

The European Union's strategy for East-Central Europe is coming apart at the seams. Supporting exchange rates at overvalued levels does not make sense and actually adds to adjustment costs. Consequently, social tension is mounting in Latvia and elsewhere. The Latvian government is struggling to reduce nominal wages; this is an almost impossible task anywhere. The government in Iceland has fallen. Fresh waves of financial market pressure are likely to move throughout the region, probably triggered by the timing of external debt rollover needs.

Worldwide, many emerging market countries will need to borrow from the IMF. Some countries will be willing to go early to the IMF, but for most the fear of a potential stigma (and desire to do well in upcoming elections) will lead them to prefer fiscal austerity (and perhaps even contractionary monetary policy) without IMF involvement. The IMF will be more engaged in smaller emerging markets, such as in East-Central Europe. But it doesn't have enough funding to make a difference for large emerging markets, whose problems are due to their own policy mix, particularly allowing the private sector to take on large debts in dollars. We should expect the IMF to lend another $100bn over the next six months (worldwide), and the G20 needs to keep talking about providing the Fund with more resources.

Larger emerging markets will not suffer collapse, but will increase (attempted) savings and, as a result, will experience slowdowns. The temptation for competitive devaluation will grow over time. But emerging markets cannot grow out of the recession through exports unless there is a strong recovery in the US or the Eurozone or both, which is unlikely. Many emerging markets are particularly hard hit by the fall in commodity prices. While some commodity prices may have reached their floors, a return to the levels of early 2008 will not happen until significant global growth has resumed, which could take years.

Political risks in China and other emerging markets create further downside risks. In our baseline, we assume no serious domestic or international disruptions in this regard.

United States

Perhaps the most fundamental barrier to economic recovery in the US is the weakness of balance sheets in the private sector. Households did not save much since the mid-1990s and reduced their savings further this decade, in part because of the increase in house prices; this was the counterpart of the large increase in the US current account deficit. Desired household saving is now increasing. The main dynamic is a fall in credit demand rather than constraints on credit supply in the US. The US corporate sector is in better shape but, faced with the disruptions of the last three months, is also seeking to pay down debt and conserve cash. Even entities with deep pockets, strong balance sheets and long investment horizons (e.g., universities, private equity) are cutting back on spending and trying to strengthen their balance sheets. This desire to save is causing major reductions in both consumption and private investment, creating the economic contraction we see all around us.

There are three major categories of potential policy responses: fiscal, financial, and monetary. However, each of them faces real constraints.

First, a substantial fiscal stimulus is already in train. The constraint on further action along this dimension, of course, is the US balance sheet. The US balance sheet is strong relative to most other industrialized countries - private sector holdings of government debt are around 40% of GDP. But the US authorities also have to worry about increasing Social Security and Medicare payments in the medium term, and so are reluctant to accumulate too much debt. The underlying problem is that fiscal policy was not sufficiently counter-cyclical during the boom. The federal fiscal stimulus will be helpful, but it will not be enough to prevent a substantial decline or quickly turn around the economy.

One view is that US government debt remains the ultimate safe haven, and this is surely true in general terms - particularly in moments of high stress. But this excellent recent presentation by John Campbell should give us pause (technical paper here). His point is that while US long bonds go through episodes when they are good hedges against prevalent risks (e.g., now and in the recent past), this is not always true. In particular, if inflation becomes an issue - think 1970s - then long bonds are really quite risky, in both popular and technical meanings of risk. You may think your bond holdings are a great hedge, but in fact they are a fairly substantial gamble that inflation will not jump upwards.

I'm supportive of the fiscal stimulus, at the currently proposed level, and I also strongly support the view that cleaning up the banking system properly will add further to our national debt - probably in the region of 10-20% of GDP, when all is said and done. (While this seems like a lot, Linda Bilmes and Nobel Laureate Joseph Stiglitz have estimated the long-term cost of the Iraq War at $3 trillion which, although this may be on the high end, is over 20% of GDP.) And I further agree that some form of housing refinance program will help slow foreclosures, and this should further increase the chances that the financial system stabilizes.

But all of this adds up. US government debt held by the private sector will probably rise, as a percent of GDP, from around 41% to somewhere above 70%. This is still manageable, but it should concentrate our minds. The net effect of our financial fiasco is to push us towards European-style government debt levels, and this obviously presses us further to reform (i.e., spend less on) Social Security and Medicare. And we really need to make sure we don't have another fiasco of similar magnitude any time in the near future.

Second, financial sector policy has not been encouraging. Despite a series of efforts that were both heroic and chaotic, the banking sector today is roughly in the same state it was in after the collapse of Lehman in September: investors do not trust bank balance sheets, further writedowns are expected, and stock prices are above zero mainly because of the option value of a successful government rescue.

Looking at the banks more directly, there are no easy answers. Dramatic bank recapitalization are controversial because this would imply effective nationalization, which is not appealing to Wall Street (and to many on Main Street). The original TARP terms from mid-October are no longer available, as they were very generous to banks and there is widespread backlash against bailouts. Also, the latest Citigroup bailout (from mid-November), recently repeated for Bank of America, is not appealing as an approach for the entire financial system as this was an even worse deal for the taxpayer. A clever financial engineering-type approach of ring-fencing bad assets, with some sort of government guarantee, is unlikely to provide a decisive breakthrough.

Let's say the government launches a comprehensive bank recapitalization and balance sheet clean-up scheme, with broad support on Capitol Hill. This bolsters confidence in the US banking system, causing a rise in equity prices and - most important - a strengthening of debt, both for banks and perhaps for leading nonbank corporates. Three international consequences seem likely.

1) This move forces the rest of the G7/G10 and the Eurozone to do the same, or something very similar. If we have very strong (and government-backed) banks in the US and somewhat more dubious banks anywhere in other industrialized countries, money will flow into the stronger US banks. Think back to the consequences of the original infectious blanket guarantees in Ireland in October; the effects now would be similar. You can think of the UK's upcoming moves either as a smart way to get ahead of this, or as something that will further a destabilizing wave of competitive recapitalizations - the policy is good, but doing it without coordination across countries can trigger Iceland-type situations.
2) If all major economies need to back the balance sheets of their banks, then we have converted our myriad banking sector problems into a single (per country) fiscal issue. Who

has sufficient resources to fully back their banks? This obviously depends on (a) initial government debt, (b) size of banks (and their problem loans, global and local), and (c) underlying budget deficit. Ireland and Greece will be in the line of fire, but other weaker Eurozone countries will also face renewed pressure. Officials are currently trying to work through this predictive analysis, and there is some thinking about preemptive preparations, but events are moving too fast - and the international policy community again can't keep up.

3) In some countries - particularly emerging markets but also perhaps some richer countries - the foreign exchange exposure of banks will matter. Here the issue will be whether the government has enough reserves to back (or buy out) these liabilities; the problems of Russia since September foreshadow this for a wide range of countries. The absolute scale of reserves does not matter as much as whether they fully cover bank debt in foreign currency. Most emerging markets face significant difficulties and need some form of external support in this scenario, particularly as both commodity and manufactured exports from these countries will continue to fall.

If, by good fortune, the US and global recession is already at its deepest - as some in the private sector now hold - then we face a tough situation but the difficulties are manageable. However, our baseline view remains that the real economy is not yet stabilized, and hence we will see worse outcomes in Q1 and Q2 of 2009 than currently expected by the consensus. Such outcomes are not yet reflected in asset prices, and the problems for banks - and the implications for fiscal sustainability - around the world will mount.

Third, monetary policy can still make a difference. In particular, we risk entering a deflationary spiral with falling prices and downward pressure on nominal wages. In mid-December, the inflation swap market implied minus 0.5% average annual inflation for the next five years (although this expectation has increased somewhat since then). Deflation is not yet completely entrenched, so it is still possible to turn the situation around. However, the Fed has not yet settled on the view that deflation is the main issue, and there is no internal consensus in favor of printing money (or focusing on increasing the monetary base).

Generating positive inflation in this environment is not easy. One way would be to talk down the dollar. The fact that this would feed into inflation is not a danger but a help in this context. Unfortunately, this would be seen as too much of a break from the tradition of a "strong dollar" and it would likely upset both Wall Street and US allies. Ultimately, probably later in 2009 (and definitely by early 2010), the US will move to a more expansionary monetary policy and manage to generate inflation. This will weaken the dollar and put pressure on other countries to follow suit - expansionary monetary policy is infectious in a way that expansionary fiscal policy is not.

Global Policy Implications

One leading anti-recession idea for the moment is a global fiscal stimulus amounting to 2% of the planet's GDP. The precise math behind this calculation is still forthcoming, but it obviously assumes a big stimulus in the US and also needs to include a pretty big fiscal expansion in Europe. (Emerging markets will barely be able to make a contribution that registers on the global scale.)

This global policy strategy is already running out of steam.

- Very few countries now find room for a fiscal stimulus; debt levels are too high and fiscal capacity is hard pressed by contingent liabilities in the banking system - particularly with an increasing probability of quasi-nationalization. As a result, the idea of a 2% of GDP global fiscal stimulus seems quite far-fetched at this point.
- Further monetary easing is therefore in the cards, especially as fears of deflation take hold, both for developed countries and emerging markets. There may now be some catching up by central banks - in that regard, see the latest Turkish move as a foreshadowing.
- Commodity prices will likely decline further as the global economic situation turns out to be worst than current consensus forecasts. As a result, official growth forecasts for most low income countries seem far too high.
- The worldwide reduction in credit continues, largely driven by lower demand for credit as households and firms try to strengthen their balance sheets by saving rather than spending.

The crisis and associated slowdown started in the US, but the recession is now global. The US economy is no more than 1/4 of the world economy, so even the largest US fiscal stimulus (say 3% of U.S. GDP per annum) cannot be not large enough to move the world at this stage. If we stabilize our financial system fully and restore consumer credit, this will help. But remember that we are subject to shocks from outside and the outlook there is worse than in the US in many ways. Outside the US the tasks look much harder.

One key principle, stated repeatedly by both the G20 and the IMF, is that policy responses need to be coordinated. This is a basic lesson of the Great Depression, when protectionist trade policies reduced exports across the board without benefiting any nation. The current crisis has not seen a widespread outbreak of higher trade barriers - although some of the bailout programs national governments have offered to domestic industries could amount to protectionist subsidies. Instead, however, we are seeing friction over currency valuations, as countries (who can afford to) try to boost their exports. In terms of recent developments, Switzerland threatened to intervene on foreign exchange markets to suppress the value of the Swiss franc. And the French finance minister criticized the U.K. for letting the pound depreciate.

In addition, fiscal constraints give national governments an incentive to reduce the size of their stimulus packages and attempt to free-ride off of other countries instead. Many countries are probably looking to the United States and hoping that our reasonably large stimulus - 6% of GDP, spread roughly over two years - will help turn around the global economy as a whole.

Looking Forward

The first order of business is clearly to revive the US and global economies. However, it is also imperative that we understand the nature of the global economic order that we live in, with the goal of minimizing the chances of a similar economic crisis in the future and the severity of such a crisis should it occur. As mentioned above, while the government balance sheet can absorb the

cost of restoring the economy this time, it is not clear how many times we can add 20% of GDP to the national debt.

We also need to recognize that financial crises, just like bubbles, will recur. Government regulators, no matter how motivated and skilled, are no match for the collective ingenuity of billions of human beings doing things that no regulator envisioned. The only real way to protect a national economy in the face of systemic financial problems is with a sufficiently strong government balance sheet (i.e., low debt relative to the government's ability to raise taxes). This requires counter-cyclical fiscal policy during a boom, which is always politically difficult. However, this implies less room for fiscal stimulus now, or alternatively the need to put in place measures that will compensate for the stimulus once the economy has recovered.

In order to create the conditions for long-term economic health, we need to identify the real structural problem that created the current situation. The underlying problem was that, after the 1980s, the "Great Moderation" of volatility in industrialized countries created the conditions under which finance became larger relative to GDP and credit could grow rapidly in any boom. In addition, globalization allowed banks to become big relative to the countries in which they are based (with Iceland as an extreme example). Financial development, while often beneficial, brings risks as well.

The global economic growth of the last several years was in reality a global, debt-financed boom, with self-fulfilling characteristics - i.e., it could have gone on for many years or it could have collapsed earlier. The US housing bubble was inflated by global capital flows, but bubbles can occur in a closed economy. The European financial bubble, including massive lending to Eastern Europe and Latin America, occurred with zero net capital flows (the Eurozone had a current account roughly in balance). China's export-driven manufacturing sector had a bubble of its own, in its case with net capital outflow (a current account surplus).

But these regional bubbles were amplified and connected by a global financial system that allowed capital to flow easily around the world. Ordinarily, by delivering capital to the places where it is most useful, global capital flows promote economic growth, in particular in the developing world. But the global system also allows bubbles to feed on money raised from anywhere in the world, exacerbating systemic risks. When billions of dollars are flowing from the richest countries in the world to Iceland, a country of 320,000 people, chasing high rates of interest, the risks of a downturn are magnified, for the people of Iceland in particular.

Ideally, global economic growth requires a rebalancing away from the financial sector and toward non-financial industries such as manufacturing, retail, and health care (for an expansion of this argument, see this op-ed). Especially in advanced economies such as the US and the UK, the financial sector has accounted for an unsustainable share of corporate profits and profit growth. The only solution is to invest in the basic ingredients of productivity growth - education, infrastructure, research and development, sound regulatory policy, and so on - so that our economy can develop new engines of growth.

Further coverage of the crisis and policy proposals

Background material
Previous editions of Baseline Scenario:

- November: http://baselinescenario.com/2008/11/10/baseline-scenario-111008/
- December: http://baselinescenario.com/2008/12/15/baseline-scenario-121508/

Financial Crisis for Beginners primer, includes recent material on "bad banks" and the Swedish approach to cleaning up the banking system: http://baselinescenario.com/financial-crisis-for-beginners/

Deeper causes of the crisis, an ongoing series: http://baselinescenario.com/category/causes/

More details on current topics
Strategies for bank recapitalization

- Economic ideas: http://baselinescenario.com/2009/01/27/to-save-the-banks-we-must-stand-up-to-the-bankers/
- Political developments: http://baselinescenario.com/2009/01/25/the-emerging-political-strategy-for-bank-recapitalization/

Global fiscal stimulus: http://baselinescenario.com/2009/01/21/global-fiscal-stimulus-should-it-be-an-obama-priority/

Citigroup bailout (the second round): http://baselinescenario.com/2008/11/27/international-implications-of-the-citigroup-bailout/ and http://baselinescenario.com/2008/11/24/citigroup-bailout-weak-arbitrary-incomprehensible/

As it happened
First edition of Baseline Scenario (September 29, 2008):
http://baselinescenario.com/2008/09/29/the-baseline-scenario-first-edition/

"The Next World War? It Could Be Financial" (October 11, 2008):
http://baselinescenario.com/2008/10/12/next-up-emerging-markets/

Pressure on emerging markets (October 12, 2008): http://baselinescenario.com/2008/10/12/next-up-emerging-markets/

Pressure on the eurozone (October 24, 2008): http://baselinescenario.com/2008/10/24/eurozone-default-risk/

Testimony to Joint Economic Committee (October 30, 2008):
http://baselinescenario.com/2008/10/30/testimony-before-joint-economic-committee-today/

Bank recapitalization options (November 25, 2008):
http://baselinescenario.com/2008/11/25/bank-recapitalization-options-and-recommendation-after-citigroup-bailout/

Chairman CONRAD. Dr. Setser, welcome. Am I pronouncing your name correctly?

Mr. SETSER. Very close, yes.

Chairman CONRAD. How do you do it?

Mr. SETSER. "Setser."

Chairman CONRAD. Great. Welcome.

STATEMENT OF BRAD W. SETSER, PH.D., FELLOW FOR GEOECONOMICS, THE COUNCIL ON FOREIGN RELATIONS

Mr. SETSER. Thank you. Chairman Conrad, Senator Gregg, members of the Committee, it is a tremendous honor to be asked to testify before you today.

As we all know, the U.S. economy began to slow in 2006 as home prices peaked and residential investments started to fall. It entered into a recession at some point in the last year. However, for a while, at least at the surface, the world economy remained relatively healthy. Unfortunately, hope that the excesses of the housing and credit boom of the past few years could be unwound gradually disappeared last autumn, and I think it is fair to say—and this is consistent with Dr. Johnson's testimony—that the extent of the slowdown in global activity now underway is hard to overstate.

The latest forecasts suggest that U.S. output will contract at a 5-percent or more annual pace in the fourth quarter of 2008. That would be one of the sharpest falls in recent U.S. history. It would also probably be one of the smallest falls when you look around the global economy. The fall in Europe looks to be comparable. The data from Japan already out suggests a 10 percent of GDP annualized contraction in the fourth quarter. Korean output contracted an annualized 20-percent pace in the fourth quarter. Chinese output growth looks to be close to flat, which is an enormous deceleration. And to the extent that the commodity exporters are doing better, it is only because they have been able to draw on the resources saved when commodity prices were high this summer.

Global output, not just U.S. output, likely fell in the last quarter of 2008, and I share the assessment of Senator Conrad and Dr. Johnson that the IMF's forecast for mildly positive global growth is optimistic.

Arresting the sharp fall in output I think requires a significant adjustment in policies. The Obama administration and the Congress are currently working on a stimulus package, which I think is essential to support output as private spending and investment contracts. And further efforts such as recapitalize the American financial system I agree are likely to be necessary. Comparable policies need to be adopted in all major economies with the capacity to do so. China I would note in that regard, but also Germany.

In my testimony, though, I want to focus less on the adjustment in the global output and the changes in the forecast to the global output, and a little bit more on the tremendous changes now underway in the global pattern of trade and the global pattern of capital flows. But first I want to state a couple of things about the global forecast.

The IMF's forecast generates slightly positive global growth because it assumes that growth in the emerging world will remain positive, although at a much lower pace than in past years. That portion of the forecast strikes me as the most optimistic portion of the forecast. As I mentioned earlier, the fall in output in Korea in the fourth quarter was stunning. It was not quite as large as the fall in output at the peak of Korea's crisis in 1998, but it was not that much smaller.

The deceleration in Chinese growth suggests that China is entering into a recession, largely because of its own internal dynamics,

at the same point in time that the global economy is entering into a recession.

Some leading indicators for Russia suggest a contraction in Russian output comparable to the contraction in 1998 during Russia's crisis—

And even Brazil, which entered into this crisis with perhaps the best position, at least on the financial side of any emerging economy, and the strongest domestic basis for growth, looks to be slowing sharply.

Broadly speaking, wherever you look it suggests a significant contraction, not an expansion, of emerging market output, perhaps a larger contraction than in the industrial world.

The second point is the shift in the pattern of global trade, and I think the simplest way to describe it is that the expansion, which was quite strong, of imports and exports globally with trade growing has gone into reverse, and it has gone into reverse in an extremely strong way. In my written testimony, I describe the fall in trade as ferocious. I think that is fair. Taiwan's exports in December were down 40 percent. Korea's and Japan's exports in December were down 20 percent. Germany's exports in November were down 10 percent.

Why does this matter for the United States? Well, one, I think it indicates that the fall in U.S. and European output—after all, the U.S. and Europe are on the receiving end of Asia's exports—is going to be quite significant. So some degree of the slowdown in Asia is a leading indicator of the slowdown in the United States. But, second—and I think I agree with Senator Conrad on this—it also suggests that, together with the recent dollar appreciation, hopes that exports will provide additional support for the U.S. economy are, unfortunately, likely to be unfounded, that the deceleration in exports in the U.S. over the next several quarters is likely to be quite significant, and I think all leading indicators of export growth point in that direction.

Now, evaluating whether imports or exports on the non-oil imports and exports side will fall faster is difficult given the scale of the changes now underway. The only thing I think we can state with some degree of certainty is that the fall in commodity prices will have a significant impact on the U.S. trade deficit. A $50-a-barrel average oil price compared to a $100-a-barrel average oil price generates, assuming no big contraction in U.S. exports to the oil-exporting economies, a $200 to $250 billion improvement in the current account deficit. So the U.S. trade deficit and current account deficit are poised to fall, which implies, if that forecast is true, the U.S. will be relying less on the rest of the world for financing than it has in the past.

That gets to my third point, the shifts in the pattern of global capital flows. Over the past several years, there has been three broad trends. One is that U.S. and European private flows both ways were growing at a quite rapid pace. Second, U.S. private investors were increasingly putting money into the fast-growing emerging world, so there was a significant private outflow into the emerging world. And then, third, the emerging economies were adding tremendous sums to their reserves and to their sovereign wealth funds. At a peak, they were probably adding $400 billion a

quarter or $1.6 trillion a year, a huge sum, in the process absorbing much of the debt that the United States issued.

The simple way to describe what has happened is that all of these flows have gone into reverse. The transatlantic flow has essentially stopped, is now actually negative, with Americans selling assets and Europeans selling assets, and generating net financing for the U.S. because the U.S. has been selling its foreign assets faster than foreigners have been selling their American assets.

The private flows into the emerging world have gone into complete reverse, and correspondingly, reserve growth in the emerging world has effectively stopped.

Now, this has not immediately translated into a fall in demand from the emerging market central banks for treasury bonds, I know a central concern of this Committee, because emerging markets have reallocated their portfolios away from riskier assets toward the treasury market. However, given the scale of the fall in emerging markets' reserves, that reallocation process will eventually come to an end, and the extent to which the U.S. will be drawing on emerging market reserve growth for financing will fall. To my mind, that is not a bad thing. I would be far more worried about an expansion of the fiscal deficit. If that expansion of the fiscal deficit corresponded not with a fall in private investment in the U.S. that the public sector was offsetting but, rather, required that the U.S. draw on the savings of the rest of the world. But the sustainability of the improvement in the U.S. current account deficit hinges not just on the policies that we adopt here, but on policies that are adopted elsewhere in the world.

I know that the scale of treasury issuance that the current deficit implies is stunning. I think we are all stunned by the scale. I would just also note that the scale of the fall in global output that we are trying to counteract is equally stunning.

Thank you.

[The prepared statement of Mr. Setser follows:]

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January 29, 2009

Testimony of

Brad Setser
Fellow, Geoeconomics
Council on Foreign Relations[1]

Before the Senate Budget Committee

The Global Outlook

[1] The Council on Foreign Relations takes no institutional position on policy issues. All statements of fact and expressions of opinion contained in this testimony are the sole responsibility of the author. The author would like to thank Arpana Pandey and Paul Swartz of the Council on Foreign Relations for help with the preparation of the charts in this testimony.

The U.S. economic growth began to slow in 2006, as home prices peaked and residential investment started to fall. The U.S. entered into a recession in the first quarter of 2008. However, much of the world economy remained, at least on the surface, healthy. Unfortunately, hope that the excesses of the housing boom could be unwound gradually disappeared last autumn. The extent of the global slowdown now underway is hard to overstate.

The latest forecasts suggest that in U.S. output contracted at a 5 percent annual pace, if not more, in the fourth quarter of 2008. That would be one of the sharpest quarterly falls in U.S. output in the last sixty years. Even so, the U.S. did substantially better than many other economies. The slowdown in most of Europe should be comparable to the slowdown in the U.S. Japanese output contracted at a 10 percent of GDP annual pace in the fourth quarter. Korean output contracted at a 20 percent of GDP annual pace. Chinese output growth was close to flat, but that implies a rapid deceleration in China's pace of growth. Commodity exporting economies are only faring better because they are still able to draw on the foreign assets they built up over the summer. Global output likely fell in the fourth quarter of 2008. The first quarter of 2009 looks similar.

Arresting this sharp fall in global output requires significant adjustments in policies. The Obama administration and the Congress are currently developing a stimulus package to support U.S. output as private spending and investment contracts. Further efforts to recapitalize the American financial sector are likely to be needed. Comparable policies should be adopted in all the major economies to halt the current, highly synchronized fall in global output.

This fall in global output has been accompanied by equally large changes in the pattern of global capital flows. In 2007, the total increase in the world's reserves exceeded $1.5 trillion, the total increase in dollar reserves exceeded of the United States current account deficit and central bank purchases of U.S. Treasuries easily exceeded the net issuance of marketable Treasuries. In the fourth quarter of 2008, global reserve growth came to halt. Falling commodity prices have reduced the external surplus of large commodity exporters and private capital is now flowing out of both commodity-exporting and commodity importing emerging economies. As a result, the majority of the Treasury's debt issuance in late 2008 was placed with private investors.

This is not a bad thing; the huge acceleration in reserve growth in 2006 and 2007 impeded necessary adjustments in the global economy—and allowed underlying vulnerabilities to build. A rise in the fiscal deficit that offsets a cyclical fall in private investment poses fewer long-term risks than a structural rise in the fiscal deficit than can only be financed by borrowing large sums from the rest of the world.

My testimony will focus less on the U.S. outlook than on the tremendous shifts now underway in the global economy, as a period of expanding trade gives way to a sharp contraction and as the pattern of capital flows that defined the global economy over the past several years reverses itself. It is organized in three sections:

The first briefly reviews the state of the global economy. The second looks at the latest trade data. The third examines recent changes in the pattern of capital flows.

A truly global contraction

The IMF currently forecasts that global activity will expand by 0.5percent in 2009—down from in 3.4 percent 2008 and 5.2 percent in 2007. Ongoing, though more subdued, growth in large emerging economies would offset a synchronized contraction in the U.S. Europe and Japan. This forecast, alas, may still be too optimistic.

The current forecast is significantly more pessimistic than IMF's forecast in November, as activity slowed faster than anticipated in the U.S., Europe, Japan and Russia (Figure 1). However, it still likely overstates growth in the world's emerging economies. A few facts are illustrative:

-- The fall in Korean output in the fourth quarter of 2008 (q4 2008), annualized, implies a fall in output comparable to the fall in output that accompanied Korea's crisis in 1997-98. Singapore and Taiwan have posted similar sharp falls in output.
-- The deceleration in China's growth in the fourth quarter of 2008 almost certainly exceeded the deceleration in China's growth in the Asian crisis, or the global electronics slump of 2000-2001. IMF's forecast of 8.5percent real growth was always optimistic, and now looks extremely optimistic.
-- Leading indicators imply a larger fall in Russian output than in Russia's 1998 crisis. The IMF is now forecasting Russian output to contract in 2009.
-- Similar indicators suggest that Brazil, which entered into the crisis in far stronger financial shape than it entered into past global downturns, will also experience a sharp contraction.
-- Almost all Eastern European economies that relied on large net capital inflows (generally from European banks) to finance large current account deficits are either in a recession or poised to enter one.

In most respects, the deceleration in the growth of the emerging world now looks sharper than the deceleration in the U.S. and Europe. An outright fall in global output—a mark of an unusually severe global contraction—looks increasingly likely.

The obvious risk is that bad news compounds: The initial fall in output gives rise to a further falls in investment, employment and consumption—dragging growth

down further. The only bright spot: the synchronized global slowdown leaves little doubt about the needed direction of the global policy response.

An enormous contraction in trade

One of the quirks of the global economy is that different nations release data on their exports and imports on a different time scale. December data is now available for all the large Asian economies, but not for the U.S. or the EU.

Usually this doesn't matter much; trade flows tend to adjust gradually. But in this case the Asian data points to a ferocious—and I use that word intentionally—fall in both intra-Asian and global trade. Taiwan's year-over-year (y/y) exports were down over 40 percent; Japan's exports were down 20percent, Korea's exports were down close to 20 percent and China exports were down 3 percent—better than the rest of Asia but still a major deceleration from the 19percent growth registered in October (Figures 2 and 3). The fall in Korean and Taiwanese exports augers further falls in China's exports, as China imports electronic components for final assembly. It also provides indirect evidence of a sharp slowdown in China's own demand.

Asian imports are down too, in part because of the fall in commodity prices. China's current account surplus is up, as the 20 percent y/y in fall in imports topped the fall in its exports. In Japan, though, the fall in exports topped the fall in imports leading Japan to post its first current account deficit in a very long time. That illustrates just how rapidly the global economy is changing.

European data isn't more encouraging. The sharp slowdown in the UK and Spain suggest a contraction in demand from Europe's large deficit countries. The slowdown in Russia and Eastern Europe will certainly feed through to Europe's exporting core German exports were down 9percent in November (Figure 4).

These contractions matter for the U.S. for two reasons. First, the fall in Asian exports likely reflects a sharp fall in U.S. demand for Asia's output—and thus provides indirect evidence of the scale of the slowdown in U.S. demand. Second, the fall in global activity, especially in conjunction with the dollar's recent rally, suggests that the U.S. should anticipate a sharp fall in its exports. November exports were down 2percent (Figure 5). West Coast outbound container traffic is down substantially more in December and January – as are leading indicators of export demand (Figure 6). It would be surprising if U.S. exports didn't fall by close to 10 percent in the December, and by even more in the first quarter.

For the past several quarters, U.S. non-oil exports have grown substantially faster than U.S. non-oil imports, bringing the non-oil deficit down. The expansion of net exports associated with the improvement in the real trade balance was a key reason why the decline in residential investment didn't produce a bigger fall in

economic output. The overall trade deficit though remained roughly constant, as the improvement in the non-oil balance was offset by a rise in the United States petroleum import bill.

The recent fall in commodity prices points to a significant improvement in the U.S. trade balance. On current trends, the January deficit could be as low as $30 billion—roughly half its peak level. As a result, the United States' need for large net capital inflows from the rest of the world is falling not rising—a point that I will return to.

The sustainability of this improvement depends on the long-term trajectory of oil prices—and the evolution of non-oil export and imports. That in turn depends in large part on whether the rest of the world joins the United States in taking strong steps to support domestic demand growth—or whether they opt instead to support their exports and rely on the reemergence of U.S. demand. The more the world does to help itself, the more it well help the U.S.—and help to limit the reemergence of macroeconomic imbalances.

A reversal of global capital flows

The pattern of global capital flows over most of the past eight years was defined by:

-- An expansion of private flows between the U.S. and Europe, with an especially large increase in private flows to and from the UK. These flows generally balanced.
-- An increase in U.S. and European demand for the financial assets of the emerging world. This increase was particularly pronounced after 2006. Broadly speaking, when the U.S. slowed and emerging economies didn't, private investment sought out higher returns in the fast-growing emerging world.[2]
-- An enormous increase in the foreign assets of emerging market central banks and sovereign funds. In the four quarters from mid 2007 to mid 2008, the governments of the emerging world added over $1.5 trillion to their foreign assets; the increase in their dollar asses likely exceeded the U.S. current account deficit. This reflected the China's growing current account surplus, the concurrent rise in oil prices and strong private capital inflows to the emerging world. As a result, emerging market governments were a large source of net financing for the U.S. and Europe.

The scale of all these flows was unprecedented. Net private capital outflows and inflows from the U.S. peaked at around 15percent of U.S. GDP in mid-2007 (Figure 7). The IMF's data indicates that (net) private inflows to emerging economies rose to $600 billion in 2007 and the first part of 2008, a sum well in excess of the large inflows that preceded the 1997-1998 Asian crisis. Emerging market reserve growth increased by a factor of about ten from 2000 to mid-2008, rising from $150 billion to an estimated $1300 billion at the end of 2007, with an additional $200 billion or so increase in the foreign assets of their sovereign funds (Figure 8) Taking into account the Treasury and agency bonds that central banks purchased through intermediaries in the UK, total central purchases of Treasuries and Agencies were comparable in scale to the U.S. trade deficit over most of 2007 and 2008 (Figure 9).[3]

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[2] To simplify, I have left out the yen carry trade. This no doubt was significant. Japanese retail investors and foreign hedge funds alike borrowed in low-yielding yen to buy higher yielding currencies. This helped push the yen down against many European currencies. It also generated significant inflows into countries like Australia. However, Japan's current account surplus though generally has been constant. The main change in the world economy, on a global level, was the expansion of the surplus of China at the same time that high oil prices pushed up the surplus of the oil-exporting economies

[3] The monthly TIC data tends to understate both Chinese and central bank purchases of U.S. bonds. The annual survey of foreign portfolio holdings of U.S. securities tends to revise the UK's estimated holdings down substantially, while revising the holdings of central banks, China and the Gulf up. My estimates use the pattern of past data revisions to provide a closer to real-time estimate of central bank demand for U.S. assets. For more, See "China's $1.7 trillion dollar bet," Center for Geoeconomic Studies Working Paper #6 (Council on Foreign Relations: New York)

Each flow has now gone into reverse.

Cross-border flows across the North Atlantic started to contract last August, when the subprime crisis first highlighted the risks of buying complex securities. These flows are now negative. Private U.S. investors are selling their foreign assets. U.S. banks are lending less to the rest of the world. And private investors abroad are selling their U.S. portfolio. Much of the expansion in these flows, in retrospect, seems to have been associated with the growth of the "shadow" financial sector: unregulated institutions that issued short-term securities to buy long-term securities were often formally based in Europe even though they sold their debt predominantly to American investors and primarily bought long-term U.S. securities.[4]

Private capital is now flowing out of the emerging economies. The pace and scale of this reversal has been comparable to the reversal that accompanied the 1997 emerging market crisis. Over $100 billion of private capital left Russia in the fourth quarter of 2008; the outflow from China likely was similar. Those emerging economies with large reserves are now drawing on those reserves to offset private outflows; those emerging economies with smaller reserves have turned to the IMF and others for crisis financing.

Central bank demand for U.S. financial assets is also poised to fall. The New York Fed's custodial data suggests a drop in (net) central bank demand for U.S. assets in December and January. This decline, though, hasn't been as sharp as the decline in the overall pace of reserve growth. Data that I track with Christian Menegatti of RGEMonitor suggests that global reserve growth stopped in the fourth quarter (Figure 10). The fall in central bank reserve growth has coincided with a massive change in the composition of reserve portfolios: Central banks are shifting from risky private fund managers and custodians to the safety of the New York Fed, and from agency bonds (Fannie Mae, Freddie Mac, Ginnie Mae) to Treasuries (Figure 11 and Figure 12). Central bank demand for Treasuries reached record levels in the fourth quarter despite the sharp slow-down in central bank reserve growth.

Even so, the rise in central bank demand for Treasuries was far smaller than the increase in Treasury issuance. As a result, central banks absorbed a much smaller share of the Treasury's total issuance in 2008 than in 2006 or 2007. For the first time in many years, the majority of the net issuance of Treasury bills and notes was absorbed by private investors, including private investors in the U.S. (Figure 13).

Looking ahead

[4] European banks that borrowed in the wholesale market to buy long-term U.S. securities had similar effect on the data – and played a similar economic role.

The surprises of the last year require treating any forecast with caution. Even those who predicted that large losses in home lending would lead to a crisis in the U.S. banking sector and a sharp slowdown in the U.S. and global economies didn't expect that a crisis that originated in the U.S. would lead the dollar to rally. It would be a surprise if an unsettled global economy followed a predictable course in 2009.

The next few quarters likely will be marked by a transition to a lower level of trade, a lower level of cross-border flows and, unfortunately, a lower level of economic output. Forecasting whether imports will fall faster than exports is hard. The only easy forecast is that the fall in the price of oil will tend to improve the current account balance of all oil-importing economies. The already observed fall in oil prices would—barring an offsetting contraction in U.S. exports to the oil producing economies—bring the U.S. current account deficit down to between 3 and 4 percent of U.S. GDP (well below its peak level of around 6 percent of U.S. GDP).

It is also likely that the pace of reserve growth will remain subdued. The fall in the pace of global reserve growth in the fourth quarter primarily reflected both large capital outflows. Banks withdraw credit from most emerging economies, hedge funds scaled back their bets on emerging market equities and Asian investors reversed their bets on the RMB's rise. If global financial conditions stabilize, the pace of these outflows should fall. Reserve growth then would converge with the emerging world's current account surplus. That surplus though should fall, largely because of the fall in the price of oil and other commodities. Even if reserve growth bounces back from its current lows, it won't reach its past highs. The slowdown in global reserve growth implies—once the current reallocation existing reserves toward Treasuries is complete—a decline in central bank demand for Treasuries. The People's Bank of China will not continue to buy $150 billion of Treasuries a quarter.

This implies that the expansion of the U.S. fiscal deficit and the Treasury issuance associated with the recapitalization of the banking system will not be financed by an increase in the United States' net borrowing from the rest of the world. The growth in the fiscal deficit, at least in 2009, is likely to offset a significant rise in the net savings of the U.S. private sector. Merrill Lynch and Goldman Sachs are both forecasting a fall in private consumption that will push the U.S. household savings rate up even as private investment falls. This will free up domestic savings to invest in Treasury bonds.

These forecasts are based on the assumption that the enormous shocks the global economy has experienced over the past six months will continue to produce enormous swings in the pattern of activity globally. It is possible that the downturn in private consumption and investment won't be as large as forecast,

and a large stimulus will end up putting pressure on the United States external deficit. But it is also possible that the downturn will be more severe. Recent economic data—especially those from outside the United States—has been far worse than expected.

The sustainability of the fall in the U.S. external deficit ultimately depends as much on the policy response of other countries as the actions of the U.S. government. The more other countries can do to generate internal demand, the more support they will offer the global economy. Others countries stimulus plans will spillover into demand for U.S. exports, just as the U.S. stimulus will spillover into demand for the exports of the rest of the world. Conversely, if the U.S. ends up doing most of the heavy lifting to support global demand, the U.S. recovery will be weaker and likely be associated with a renewed rise in the United States' external deficit.

The scale of the issuance of Treasuries associated with the need to support U.S. demand and finance the necessary recapitalization of the financial sector is shocking. But so too is the scale of the recent downturn in U.S. —and global— activity. The risk of doing too little remains larger than the risk of doing too much. That is true for the U.S. It is also true for the world's other major economies.

Figure 1: U.S. purchasing managers survey (ISM) signs sharp decline in activity

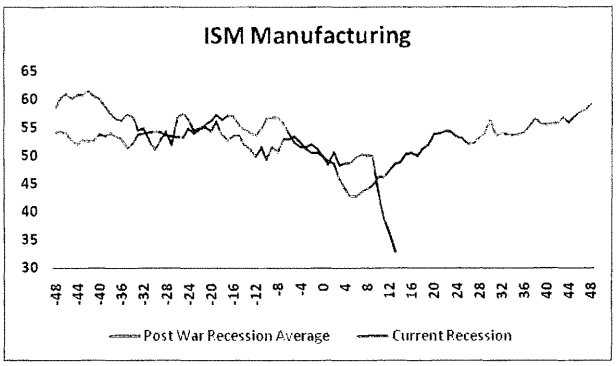


Figure 2: Asian exports (y/y change in $ billion)

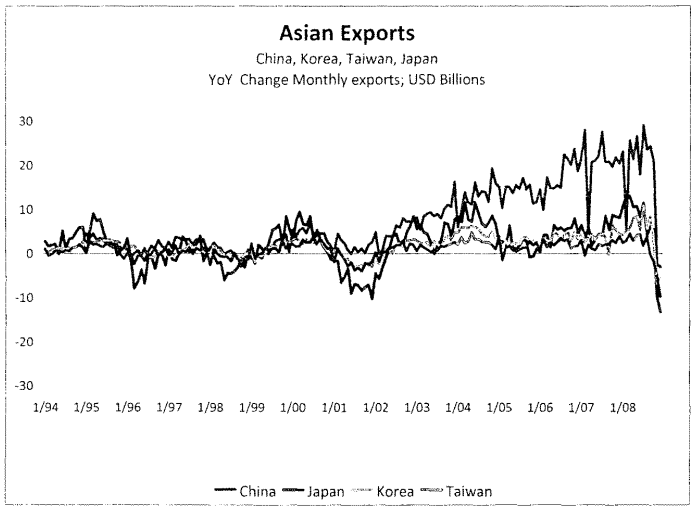


Figure 3: Asian exports: y/y percentage change, national data

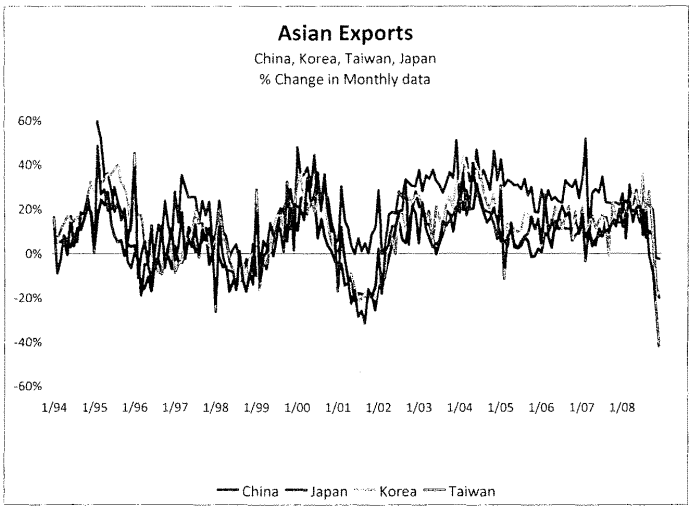


Figure 4: German exports: y/y change, in euros billion

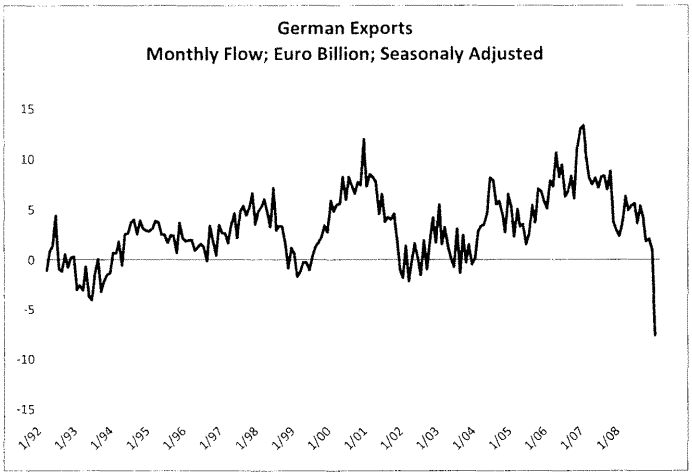


Figure 5: y/y percent change in U.S. non-oil export and import growth.

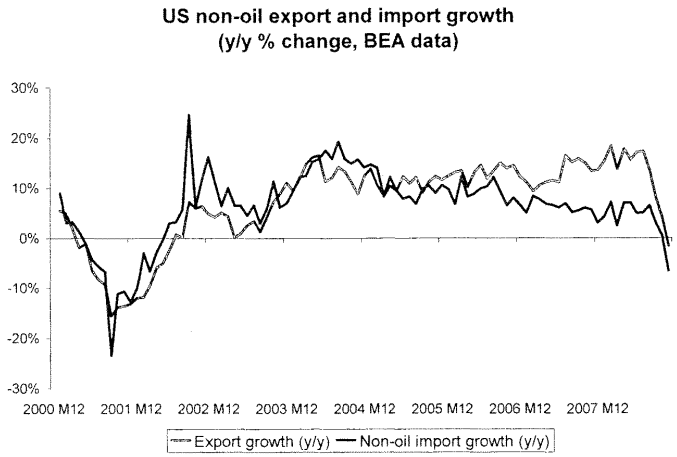


Figure 6: ISM export orders

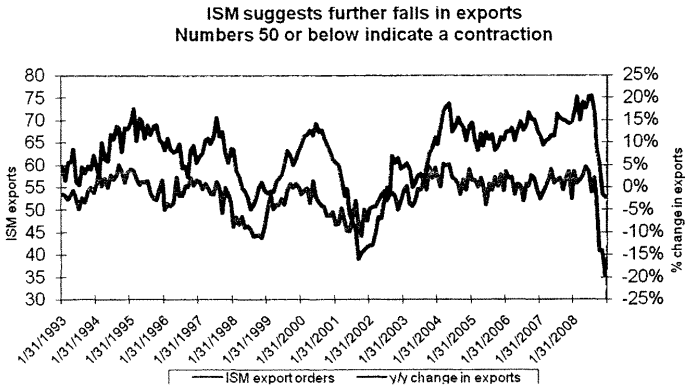


Figure 7: Private capital inflows and outflows. U.S. BEA data. Treasury purchases have been subtracted from private inflows from q3 2007 to account for likely future revisions (in the past, these purchases have been reattributed to the official sector in the revised data).

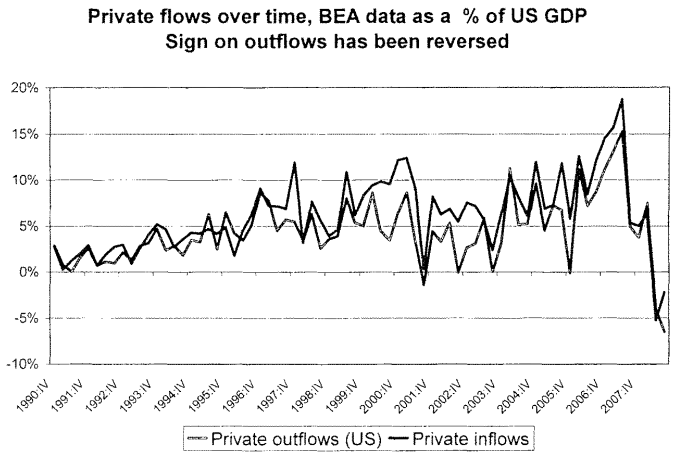


Figure 8: Global reserve growth and estimated dollar reserve growth: IMF data and Setser estimates

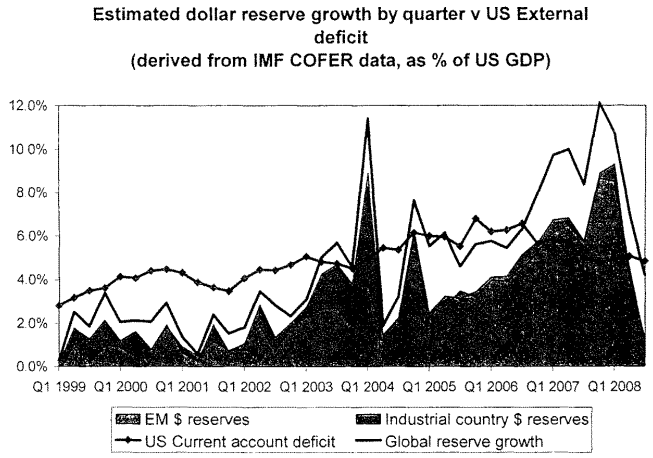


Figure 9: Estimated official purchases of Treasuries and Agencies: rolling 12m averages

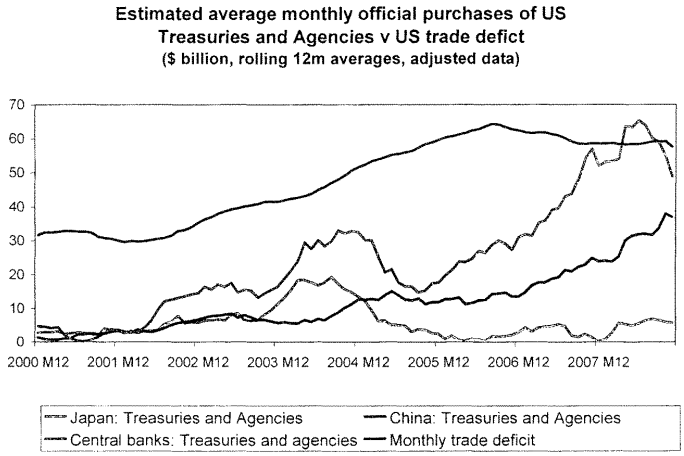


Figure 10: National data points to a further slowdown in reserve growth in q4 2008

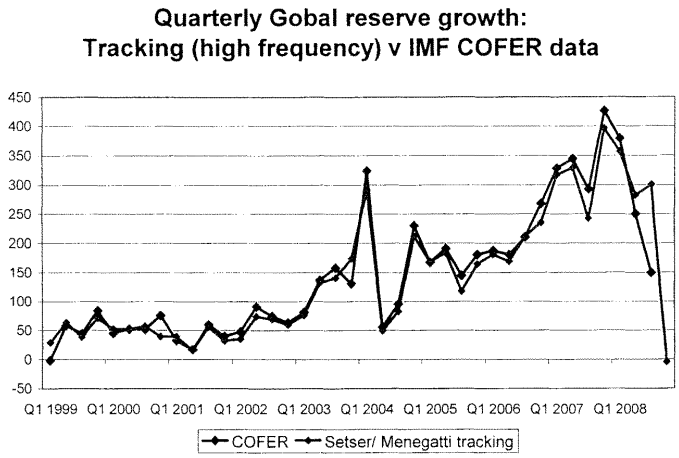


Figure 11: Chinese purchases of U.S. assets: Setser estimates based on the TIC data

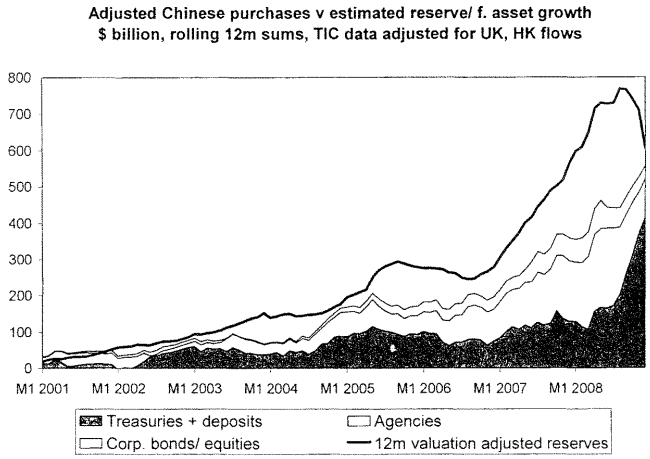


Figure 12: Y/y change (in $ billion) in foreign central banks custodial holdings at the New York Fed

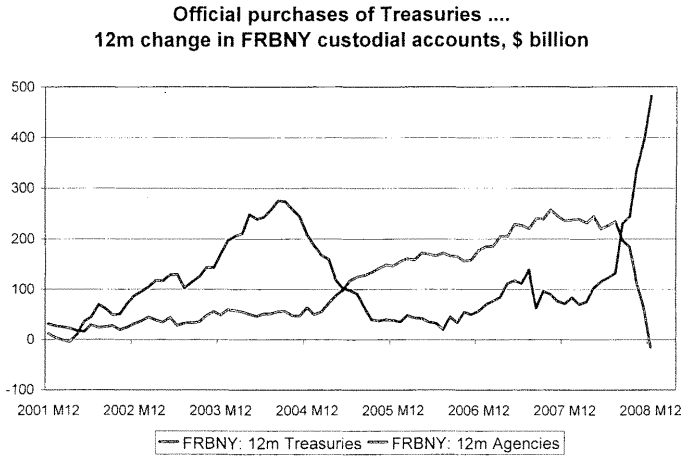
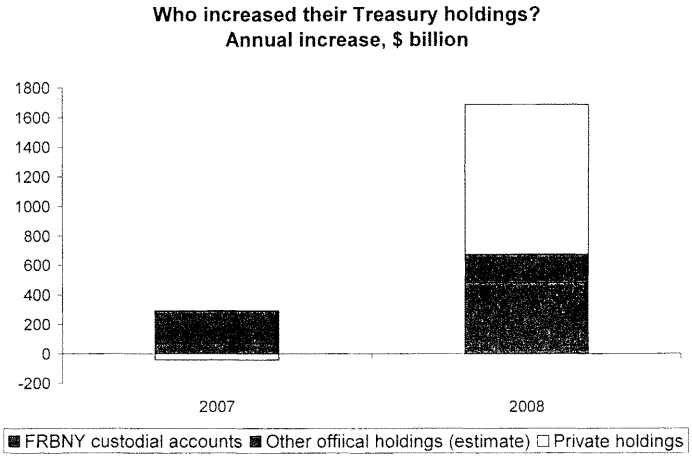


Figure 13: Official demand v U.S. issuance of marketable Treasuries (adjusted to reflect Treasuries released from the balance sheet of the Federal Reserve)



Chairman CONRAD. Yes, this has been a happy morning so far. [Laughter.]

Chairman CONRAD. Well, Tim, we are going to count on you to lift us up. Tim Adams, formerly the Under Secretary for International Affairs at the Treasury, and now Managing Director of the Lindsey Group. Again, welcome to the Committee.

STATEMENT OF TIM ADAMS, MANAGING DIRECTOR, THE LINDSEY GROUP

Mr. ADAMS. Thank you, Mr. Chairman and Senator Gregg and members of the Committee. I wish I could cheer you up. What I will do is avoid repeating the flurry of statistics that you have heard here today. They are all in my testimony as well. They are accurate and they are sobering, and they will probably get worse before they get better. And it does not matter if you are looking at Norway or New Zealand or Nigeria or the Czech Republic. This is a crisis which has engulfed the entire global economy, and we should think about that as we try to craft solutions—solutions which will require a global response.

And policymakers have responded in extraordinary ways, and they should be applauded. Central bankers, Ben Bernanke and others, have taken unimaginable policy adjustments—cutting rates to zero. The Bank of England has cut rates to its lower level in over 300 years, and they have employed their balance sheets in ways which we never thought possible or possibly prudent, but we have to do so now in order to manage downside risk.

Fiscal policy as well, we are seeing around the world countries, where possible—and Dr. Simon Johnson noted that there are many countries unable to pursue additional fiscal stimulus. Those who have are doing so, and doing so in a large manner, but need to do more.

Despite these best efforts, we are going to have a very tough 2009 and probably a very tough 2010. Banks will remain unwilling to lend. Consumers will remain unwilling to borrow, unable to borrow, businesses probably unlikely to borrow, and the emerging market conditions which have been outlined earlier will remain in place and probably become more acute. There is a great sucking sound coming out of the emerging markets, and that is capital being withdrawn. We saw just in the last 3 years $1.3 trillion worth of bank lending into corporates in the emerging markets. That is now a trickle. Foreign direct investment has gone to a trickle. That means an additional drop in activity, and probably widespread corporate bankruptcies in many emerging markets, and it will be interesting to see how the sovereigns, the governments in those emerging markets respond to those bankruptcies.

So what do you do? Well, there are a variety of things, Mr. Chairman. I believe we do need a large fiscal stimulus program. I agree with you about your concerns regarding what the House passed. And I agree with your phrase of "temporary and timely and targeted." And I am not sure the House bill meets that standard.

And I am less worried about the overall level, although we certainly need something on the order of 3 or 4 or 5 percent of GDP. It is the composition that matters. We need to get the spending into the system and get it in immediately, and I want to echo what former Congressional Budget Office Director Alice Rivlin said yesterday, that maybe what we ought to do is separate this bill into two pieces—that which can actually, the majority of which can get into the spending cycle this year, and a lot of other worthy projects that do not get put in place for a number of years, set them aside and come back and look at those in a more methodical and intelligent fashion.

We also need to stabilize housing—you noted that and Senator Gregg noted that—the critical underlying piece of our economic crisis, and we need to stabilize banking and we need to do that by getting the toxic assets off the balance sheets and into some other form or other vehicle, and that magnitude could be somewhere between $1 trillion and possibly $3 or $4 trillion. So I suspect the administration will come back to this Committee and to Congress for additional funding.

We need to shrink from the IMF. Simon noted that we have seen in our experience in a number of programs that the Fund has put in place, a number of funding programs. I think these are critical. The IMF, which appeared to be out of business 24 months, is now back in business and working 24/7 in order to address the macroeconomic challenges that we are seeing around the world. The previous administration sent to Congress an IMF reform package. I would urge the members of this Committee to look at that package, and I would urge this body and Congress to pass that reform package as soon as possible. It is not perfect. There are things I would love to see different to it. But it is what it is. It was negotiated multilaterally, and we need to give our stamp of approval to the Fund. Irrespective of how you may have felt about previous actions, we need to give this institution the resources and stature to do the job it is currently doing.

We need to address global imbalances. The growth model that has been in place over the past 10 years where excess savers around the world—namely, in Asia—ship us their savings; we use the savings to live beyond our means—namely, by buying products from those places. That model is broken, and it is not coming back. And we need to think about what model is going to drive us out of this cycle, because the U.S. consumer is not going to lead us and, as we heard from Dr. Setser, nor is exports. So we need to think collectively about what is the growth model and how do we return to an expansionary phase in this cycle.

And, last, stabilize the long-run fiscal outlook for the country. We are going to issue a tremendous amount of debt over the next 2 years, and if you look at CBO's I think optimistic analysis, we will add $3 trillion in deficits over the next 10 years. The Concord Coalition says it is $10 trillion. It does not really matter—$3 trillion, $10 trillion. After a while, the numbers are staggering. And we do run the risk of the world choking on the amount of treasuries we are going to push out the door. And also remember that a whole host of other countries are going to be pushing their bonds out the door as well. So the competition for loanable funds is going to be enormous, and the implications are great.

I would just again add that we need to act with enormous speed, but we need to act wisely. We need to spend money wisely. We need to focus on the short term and deal with the problems the Chairman and Senator Gregg noted—housing and banking—but we need to make sure that we keep an eye on the long term so that we do not undermine our ability to function in the future.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Adams follows:]

Testimony by Tim Adams
Senate Budget Committee
Hearing on the Global Economy: Outlook, Risks and Implications
Thursday, January 29th, 2009

Overview of current conditions

The economic and financial crisis that has engulfed the United States over the past year is now cascading throughout the global economy, producing a painful, sudden, synchronized global contraction. The IMF has once again revised downward its estimate for global growth in 2009 to the lowest in over 25 years and to just a fraction of the 5% pace seen in 2007. Many noted private forecasts are even more pessimistic, expecting negative global growth this year, possibly shattering all post-war records for a global slowdown. The World Bank estimates that global trade will decline this year for the first time in a quarter-century. The likely global wealth loss from this crisis could exceed $50 trillion, which is more than global GDP.

The G7 economies, which compose roughly half of global GDP, are experiencing the first synchronized recession in the post-war era. The U.S. economy likely shrank about 5% in the last quarter and will likely continue to contract during the current year, even with a sizable stimulus in place. Germany, the world's fourth largest economy and top global exporter, will likely suffer its worst economic performance in its modern history. The UK economy is forecasted to shrink the most since 1946, with the Pound Sterling already plummeting to a 23-year low. Japan is in the midst of a severe and protracted contraction, with exports plummeting and crude-steel output sinking in December by the largest amount in 60 years. In short, the economies of the developed world have ground to a halt.

The emerging market economies are mirroring the downturn in the developed world. China, now the world's third largest economy and along with the U.S. one of the key drivers of growth during the recent expansion, is experiencing economic challenges not seen since the Asia Financial crisis a decade ago. China's growth has slowed from a blistering 13% pace in 2007 to a relatively languid 7% this year (with downside risk), a level that is regarded as insufficient to generate enough jobs to meet demand. But China is not alone. Asia broadly is suffering, proving wrong the oft-repeated quip of the past few years that the region had "decoupled" from the U.S., insulating it from possible weaknesses and shocks from outside the region. For example, Korea's fourth quarter 2008 GDP growth collapsed a staggering -21 percent (annualized quarter over quarter), and Singapore an equally stunning -17 percent, the biggest drop on record. Finally, India will likely suffer a growth rate this year that's at best just half the pace of last year.

The world's principal commodities producers, who just nine months ago were in an enviable position of benefiting from stratospheric price levels, have been whipsawed by a freefall in prices. With oil prices plummeting by roughly $100 a barrel, from a record $147 in July of 2008, the oil producers are under enormous financial and fiscal stress. Russia has experienced and is experiencing a substantial outflow of capital, a collapsing Ruble, a sizable loss of official reserves (i.e., roughly $130 billion or 30% of holdings) and a large swing in its external position from positive to negative. The GCC economies are facing the toughest conditions in decades with many of the economies suffering budget deficits and slumping activity. Dubai, one of the seven emirates composing the United Arab Emirates, and a symbol of globalization and leverage-generated wealth of this past expansion, is witnessing a cooling of its renowned economic boom. One noted multinational heavy equipment manufacturing firm commented

just last week that construction activity and crane demand in the region had simply "evaporated." The non-oil commodities producers, such as copper exporters Chile and Zambia and iron ore producers Brazil and Australia are also experiencing falling demand and plummeting exports.

Needless to say, these are sobering statistics, reflecting an unprecedented period in modern economic history where no part of the global economy -- from Norway to Nigeria to New Zealand -- is immune from this crisis and the painful contraction in economic activity.

Key Challenges Ahead

The world's policymakers have responded with imagination and alacrity, implementing polices well outside the conventional textbook suggested options and instruments. Central banks have slashed rates to historic levels, with the Federal Reserve pushing its Fed Funds rate to near zero and the Bank of England cutting rates to the lowest level in over 300 years. Central banks have also moved to employ their balance sheets in ways and magnitudes unimaginable just a year ago in an effort to re-liquefy financial markets, unfreeze credit channels and address concerns of financial counter-party risk. The world's principal central bankers should be applauded for these efforts and for their willingness to undertake extraordinary action to combat this crisis. That said, many central banks around the world have plenty of room to reduce rates further and ease monetary conditions employing a variety of tools. They should do so quickly. For example, the European Central Bank (ECB) has cut rates an aggressive 225 bp over the past four months to a record low 2%. But, given that the European Commission is forecasting that the 16-nation Euro area will contract by 1.9% this year, inflation has plunged to 1.6% in December from 4% last July and the banking system remains highly fragile, the ECB can and should push rates lower as soon as possible.

Officials worldwide have also turned to fiscal policy, with most of the major economies having enacted or currently enacting sizable spending and tax cut programs. For example, the U.K has approved a package equal to roughly 1% of GDP, mostly through changes in the VAT, Japan a package of about 1.1% of GDP, the Euro area about 2% of GDP, China 15% (over two years) and Korea 3.7% of GDP. Despite this effort, the deepening nature of this crisis will likely require even more fiscal stimulus. The estimate of the size of needed additional stimulus varies based on expectations of global growth and country specific demand shortfalls, but may be as much as $2 trillion globally. Additional fiscal stimulus would be most welcome and should occur in those countries with large or growing savings rates and moderate to low debt to GDP levels (i.e., those with the capacity to enlarge their deficits). Both Germany and China fit this description and, given their economic size, could have a significant impact on global growth.

Despite aggressive monetary and fiscal policy measures, the next year (or two) will still prove challenging. The global financial deleveraging process will continue. Banks will continue to rebuild their balance sheets and remain reluctant to extend new credit. Private capital will likely avoid the banking sector, paralyzed by the uncertainty over asset quality and expected sweeping changes to the U.S. and likely European regulatory regimes. The demand for credit will also remain weak. Many U.S. consumers face negative equity on their homes, auto loans that exceed the residual value of their vehicles, depleted savings and 401K accounts, stagnated wages and one of the worst labor markets in twenty-five years. For many of the country's 77 million baby boomers, retirement now seems unrealistic in the near-term and most will have to set aside a greater portion of income to compensate for the roughly $11 trillion (or 20%) wealth loss that's occurred through the end of 2008. Corporations will also prove

unwilling to borrow for expansion, facing weak demand for goods and services, little or no pricing power, excess capacity and pension fund shortfalls that may exceed a half a trillion dollars. In short, neither the supply nor demand conditions for credit are likely to improve much in 2009.

The credit crunch is also slamming the already highly weakened emerging market economies (EMs). During the 2002 to 2008 expansion, emerging markets boomed, experiencing a solid average annual growth rate of 7%. During this time, many implemented sound polices, such as reducing deficits, reducing foreign exchange denominated debt, accumulating reserves and moving to flexible exchange rates. Such policies and good economic performance created a fertile environment to attract capital, and many of the EMs did attract capital, especially the corporate sector. JP Morgan notes that emerging market corporates borrowed (direct and syndicated lending) over $1.3 trillion for the three year period of 2006 -2008. These corporate borrowers will need to rollover roughly $200 billion of debt during this current calendar year, which will prove incredibly difficult to accomplish. Fortunately, U.S. banks have little direct exposure, in fact just only 11% of the $4.7 trillion in total outstanding bank lending to the emerging markets. Unfortunately, European banks are highly vulnerable, having about 74% or $3.4 trillion in exposure, and are likely to face losses over the coming year.

In addition to portfolio flows, Emerging Markets are also suffering from a drop off in foreign direct investment. The World Bank, in its latest Global Development Finance Report, predicts that FDI into the developing economies will slump by whopping $180 billion or 31% in 2009, following on a 10% decline last year. Given that FDI accounts for 40% of total flows to the developing world, such a substantial decline will further depress growth and weigh on the value of EM currencies.

With the collapse in commodity prices, the loss of capital flows (and in some instances capital flight), swooning currency values, increasing austerity measures and faltering growth, political pressures in many countries are heating to a boil. Press reports just this week note riots and social unrest throughout Eastern and Central Europe, Russia, Iceland and Ukraine. Thousands of other disturbances are occurring in Asia, Africa and the Middle East but don't make the pages of the daily U.S. papers. China too is not immune to the pressures of faltering growth, with unemployment now likely above 10%. There are mass layoffs in the coastal, export-oriented provinces, where over 7 million of the country's 130 million migrant work force have left to return home. U.S. foreign and development assistance policy will need to be attuned to these trends and to the plight of those most vulnerable to swings in commodity prices and the sharp edge of a faltering business cycle. In fact, The World Bank estimates that this crisis has pushed 100 million people back into poverty, a trend that will continue placing enormous strain on development organizations and budgets.

One of the great challenges over the next year is determining, and managing where possible, a new growth model to replace the one that has powered global demand for the past decade. That model is best described as where countries with excess savings, namely but not exclusively in Asia, cycled those savings primarily into the U.S. where cheap and abundant credit inflated asset values, pumped up residential investment, increased financial leverage and supported consumption well in excess of incomes. This so called Bretton Woods II system appeared at the time to offer benefits to both the capital importers and the goods exporters. In fact, between 2002 and 2007, the U.S. and China alone accounted for close to half of global economic growth. However, many government officials, including myself, were concerned that these imbalances were not sustainable and likely distorting capital in a sub-optimal fashion. Starting in 2005, we (the Bush Administration) worked with the G7, the G20, the IMF and other institutions and forum to address these imbalances. Obviously, we did not know at the time

the extent of the miss-allocation of capital or the speed with which they might unwind, but we did appreciate the unsustainable nature of this system.

Now, this U.S consumer-led dollar recycling phenomenon has likely run its course, or at least has dissipated in potency, as US households will save more -- possibly dramatically more -- and consume less to help rebuild tattered balance sheets and respond to reduced wealth holdings and possible loss of income. Thus, the imbalances are correcting somewhat automatically. If this indeed continues, the global economy will need a source of growth beyond the U.S. consumer to help lead us into a new expansionary phase.

Implications for U.S. Policy

These challenges will require additional actions from policymakers. Some suggestions are as follows:

1.) **Additional, meaningful fiscal stimulus**. Without question, the U.S. economy needs a large and immediate fiscal stimulus package to address insufficient demand and rising unemployment, now 7.2% and heading higher. The $850 billion top line estimate for the proposed package currently winding its way through the Congressional process is likely would be sufficient to achieve the stated objective. However, it is critically important that the composition of the package be such that the funds are spent as quickly as possible, ideally within the current calendar year, and pass some level of cost-benefit analysis. According to preliminary analysis from the Congressional Budget Office and the Joint Tax Committee, the current package offers only a modest level of current year stimulus -- just $170 billion of the $850 billion package. I would strongly urge this Committee to set aside those components where the majority of the effect is outside the current calendar year window, or certainly outside the next 18 months, and evaluate those items through the normal appropriations and budget process. This is not to say that these items are unworthy of support, many of them will prove beneficial over the long term, but they are not what are commonly accepted as "stimulus." For example, the proposed wireless and broadband deployment grants program will see only $10 million of the overall $2.8 billion budget spent in 2009 with the bulk (i.e., $2 billion) not occurring until 2012 and beyond, when the economy will certainly be in recovery. We also need to see additional fiscal stimulus from other key economies, especially in Europe and Asia, with a heavy emphasis on supporting near-term domestic consumption.

2.) **Stabilize and restore confidence in the banking sector**. Despite having experienced more than $1 trillion in write downs and credit losses over the past year and receiving hundreds of billions in government assistance, the banking sector still suffers from uncertainty over the sufficiency of its capital base and quality of assets on the balance sheet. Until this uncertainty is resolved, banks will remain unwilling to extend new credit, which is critical to spurring economic growth and recovery. The new Administration should use a portion of the $350 billion of the second tranche of the TARP funding to stabilize the housing market, which underlies many of the assets on banks' balance sheets, and use the remaining portion of the TARP to either remove troubled assets from the banks or at least ring-fence them in a way to insure against the downside risk of further deterioration. Given that the extent of the troubled assets is probably at least $1 trillion and quite possibly as high $3 trillion, the Administration will likely need to seek additional resources from the Congress. Another possible policy path would be for the Federal Reserve to purchase assets by expanding its balance sheet. The TARP funding could then be applied to just the expected present value of the calculated credit risk or loss, allowing the Fed to leverage the $250 billion or $300 billion to as much as $2.5 trillion to $3 trillion in actual asset purchases.

Stabilizing the banking sector is a necessary but not sufficient condition to ensuring a healthy and well functioning financial system. The Administration and Congress need to fix the numerous problems and failures that led to this crisis. Currently, there is enormous uncertainty as to how and when officials will begin crafting a new regulatory regime. This uncertainty is keeping tens of billions of dollars in private capital on the sidelines and out of the capital structure of the industry. To reduce this uncertainty, officials need to begin signaling the contours and composition of a comprehensive regulatory reform proposal. I strongly urge the Congress to consider the just-issued Group of 30 (G30) report entitled Financial Reform: A Framework for Financial Stability. The Report offers a thoughtful, broad-sweeping response.

3.) **Strengthen the International Monetary Fund and support development assistance**. Given the breadth and depth of this fast-moving global financial crisis, the International Monetary Fund has been thrust back into a central role of promoting macroeconomic stability among its member states. Over the past several months, the Fund has extended tens of billions in financing to such countries as Pakistan ($7.6b), Hungary ($15.7b), Ukraine ($16.4b), Iceland ($2.1b) and Lativa ($2.34b) to stabilize their fragile economies. The Fund is in discussion with several other key economies and has also set up a large liquidity facility for good performing economies that are innocently suffering collateral damage from global events. As this crisis spreads, it's highly likely that the Fund will need to tap a large share of it resources and could potentially exhaust available lending balances. In the spring of 2008 the IMF shareholders agreed to submit to members a comprehensive reform package. The Bush Administration submitted this package to the Congress in November of last year. The package includes such changes as a quota increase, re-balancing of voting rights , flexibility in how the Fund manages its investment portfolio and proposes a sale of a small percentage (about 12.5%) of it gold holding. While I would like to have seen a more robust reform proposal, especially regarding issues of governance and resources, I would urge the Congress to approve this package as soon as possible to ensure that the IMF has the legitimacy, stature and resources to serve its critical role in global macro-economic stability.

We should also ensure that world's poor and most vulnerable do not suffer greatly in this crisis. Mounting budget deficits and overwhelming domestic priorities will likely strain the developed world's capacity to meet, let alone exceed, development assistance pledges. This is no time to short-change our commitments and I urge the Congress to ensure that our bilateral and multilateral assistance obligations are fully funded.

4.) **Address global imbalances**. As a result of the expected large increase in the U.S. household saving rate and dramatic fall in consumption and investment, we will likely witness some dissipation in the large imbalances that have characterized the global economy over the past decade. However, policymakers should endeavor to undertake additional policies to further reduce these imbalances but do so in a way consistent with restoring global growth as quickly as possible and maximizing global growth over time. More specifically, the larger surplus countries (e.g., China, Germany, Japan, etc) should significantly increase domestic consumption and reduce domestic savings. Indeed, China has announced a large stimulus plans (15% of GDP over two years) and the EU has cobbled together a meaningful plan as well. More needs to be done, but the composition is critical. We also need to see greater currency flexibility in those places that it does not now occur, but we should proceed cautiously in the short-term to avoid unnecessary and potentially destabilizing currency volatility and actions that might trigger protectionist responses or "beggar thy neighbor" actions. The fragility of the global economy and financial system cannot now withstand a trade skirmish or confrontation. Further,

addressing issues of the appropriateness of exchange rate regimes and levels is best done via the multilateral channels of the IMF, which has such responsibilities as its central mandate. Addressing exchange rate issues just bilaterally will be regarded by many as lacking international legitimacy and driven by domestic political demands and agendas, and thus unlikely to achieve its objective.

5.) **Stabilize the long run fiscal outlook**. The historically large deficits that we will run over the next couple of years (a post- WWII high of 8.3% of GDP this year alone) may be a necessary cost of returning the U.S. and global economies to a positive and sustainable rate of growth. However, the medium- to long-run fiscal outlook is not sustainable and, ultimately, deficits do matter as there are limits to the willingness and ability of investors to absorb such large sums of debt. Federal spending as a percentage of GDP will surge to around 25% this year, up from 20% in 2007. But longer term, outlays will rise as mandatory programs, now 8.5% of GDP and steadily increasing to 14.1% by 2030, take a larger share of our economic output. Revenues are expected to fall from 2007's 18.8% of GDP to around 16.5% this year and then normalize over time, but this normalization assumes that all the Bush Administration tax cuts are allowed to expire in 2010 and that the Alternative Minimum Tax (AMT) is no longer "patched" and thus sweeping in millions of taxpayers. The CBO's most recent analysis projects an additional $3.1 trillion in deficits over the next ten years. This projection contains many optimistic assumptions, such as the expiring tax cuts and the end of AMT relief, and thus likely understates what will actually occur. The Concord Coalition has done its own analysis based on the CBO's projects, forecasting an eye-popping $10.3 trillion increase in deficits over that period of time. This is on top of an already mountain of debt (i.e., $10 plus trillion) and enormous unfunded liabilities, which the Peterson Foundation estimates at $56 trillion. Moreover, reforming mandatory programs now, with most of the changes occurring in the out-years, would not negatively impact the near-term stimulus objective but would help bend the trend lines back towards a more sustainable pathway. Once Congress has finished its most pressing task of passing a stimulus package, it is imperative that we act swiftly and comprehensively to put our nation's financial future on a sound and sustainable basis or lest we may face other, more damaging crises in the future.

Conclusion

In sum, the global economy faces its greatest challenge in over a quarter-century, and possibly in the post-war World War II era. Policymakers need to move quickly and intelligently on a broad range of fronts. We need a substantial fiscal stimulus package to return growth to a positive and sustainable trajectory but we should spend wisely, remembering that once past this crisis we will need to significantly adjust our fiscal trends to a more sustainable basis. We need to stabilize the capital structure of the banking system by removing or ring-fencing bad assets and quickly outlining the contours and composition of a new regulatory structure. We need to support our multilateral institutions, especially the International Monetary Fund, in its efforts to promote macro-economic stability and assist those most vulnerable to an economic downturn. We need to find a new growth model that is not reliant on U.S. consumer-led, debt-financed consumption. Finally, we need to invest in the productive capacity of our country, especially in human capital, so that we can raise living standards and retain our position as an economic leader.

Chairman CONRAD. Thank you very much.

I now have a blow-up of the article in this morning's Financial Times: "Economic pain to be 'worst for 60 years.'"

FINANCIAL TIMES

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Economic pain to be 'worst for 60 years'

Warning that 50m people could lose jobs

House passes $819bn fiscal stimulus plan

By Krishna Guha and Alan Beattie in Washington and Chris Giles in Davos

The world economy will this year suffer its worst performance for more than 60 years with a serious risk that 50m people will lose their jobs, international organisations warned yesterday.

The warnings came as the House of Representatives passed an $819bn version of the fiscal stimulus plan, and the Federal Reserve expressed fresh concern about deflation. The Fed said the US economy had "weakened further" since its last policy meeting in December.

The US central bank made no immediate move to purchase Treasury securities – disappointing some in the markets. The yield on 10-year Treasuries rose 14 basis points to 2.965 per cent.

Earlier, the International Monetary Fund increased its estimate of credit losses on US-based assets from $1,400bn to $2,200bn. It also said world output, measured at market exchange rates, would fall in 2009 for the first time since the second world war. Weighted by purchasing power, growth would be very slightly positive.

The new growth forecasts mark a huge revision – down by more than 1.5 percentage points – from the IMF's previous forecast for the year in spite of the inclusion of the fiscal stimulus efforts by governments into its predictions for the first time. Advanced economies, the IMF predicted, would contract 2 per cent in 2009, with the UK hit hardest.

In Geneva, the International Labour Organisation said the global recession would lead to a "dramatic increase" in unemployment this year, which would certainly lead to 18m-30m additional unemployed and more than 50m "if the situation continues to deteriorate".

The forecasts helped frame a sombre mood as executives and policymakers started the annual meeting of the World Economic Forum in Davos, with leaders stressing the sharp and synchronised nature of the downturn, expressing concern about global policy coordination and some scepticism that fiscal interventions would ensure a recovery.

President Barack Obama, meanwhile, hosted a meeting with US corporate leaders to rally support for the fiscal stimulus plan amid resistance from Republicans opposed to massive government spending, who voted unanimously against the bill in the House.

The Fed said it was prepared to buy long-term Treasury securities if circumstances suggested this would be effective in bringing down borrowing costs for households and businesses. But it signalled its inclination was to fight economic risks with more targeted credit programmes, and possibly further acquisition of securities issued by Fannie Mae and Freddie Mac.

Analysts appeared confused as to whether the statement brought the Fed closer to actually buying Treasuries.

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In that article, they note that the losses in the financial sector in the United States, they have increased their estimates—this is the International Monetary Fund—increased its estimates of credit losses on U.S.-based assets from $1.4 trillion to $2.2 trillion. You know, yesterday we were talking in this Committee about a trillion dollars, $2 trillion globally, $1 trillion here. That leads me, Dr. Johnson, to my first question, if I could.

With respect to the economic recovery package that has come from the House, have you had a chance to review it?

Mr. JOHNSON. Yes, sir.

Chairman CONRAD. How would you evaluate it in terms of being responsive to the crisis that we are in?

Mr. JOHNSON. I think it is responsive, I think it is certainly attempting to be responsive. I have been arguing, I think at least since November when I previously appeared before this Committee, that fiscal stimulus would not be sufficient. So I think, you know, while we can certainly have, continue to have a debate about the composition of the exact level—I think I suggested slightly lower numbers in November—what worries me most of all is, I think, what you and Senator Gregg and the other speakers have all alluded to, which is: What are we doing about banking exactly, and with what money? And what are we doing about housing and, again, with what money?

So I think my current position would be not to focus too much or get bogged down in a debate on the fiscal stimulus. I think you could adjust a little bit one way or the other, but I would keep it roughly as it is. Remember, the effect on financial markets if it gets stuck or if it gets massively cut back would be, I think, quite negative.

Instead, I think you should take up the points that I think I have heard you make over the past few weeks, actually, Senator Conrad, which is let us think about the financial system now, let us think about it comprehensively and on a complete scale, rather than coming back in 4 or 5 months and saying, Oops, you know, we did not right-size the package last time and we regret it.

Now, obviously, the scale of these things is a little bit different because fiscal stimulus is money you spend and then it is gone; whereas, money that you put into the banking system is hopefully an investment on which you will not lose the full amount. But I think these global loss figures that you are talking about are consistent with the view that there are a total amount of losses to be absorbed in the U.S. financial system of around between $1 and $2 trillion for U.S. residents. Obviously, the $2.2 trillion is based on a particular view of where we are in the global cycle. The main reason the IMF numbers have gotten worse is the cycle continues to surprise them in terms of the debt and the associated losses.

Chairman CONRAD. It continues to surprise them on the downside.

Mr. JOHNSON. On the downside. Yes, absolutely. So their methodology I think has held up very well, but their take on the macroeconomy has, unfortunately, been rather too sanguine of late.

Now, if we were to just take these rough rules of thumb, how much would you need to provide or think through? I think you have to consider losses for U.S. residents between $1 and $2 trillion. And the question is: How much of that is absorbed by the Government in the form of higher debt, ultimately? And how much of that can be transferred to somebody else? The equity holders, of course, have already lost their stake, and it may be unwise to push too much onto creditors given what we saw after the failure of Lehman.

Now, but in order to manage that process of losses of $1 to $2 trillion, you probably need an operation, a Government-backed recapitalization and some form of clean-up of the balance sheet of these banks that will be considerably larger. I think I would put that—let us go at the working capital the Government would need for this operation—between $3 to $4 trillion, which is a large

amount of money, I understand, but that is not the total budget cost. It is not how it would be scored for your budget. It is not what you would expect to lose. It is the amount of money you would need to provide in terms of being able to recapitalize properly and withdraw in some form the toxic assets.

Chairman CONRAD. Let me stop you on just that point. What I just heard you say is that we would need working capital to deal with the financial crisis alone of $3 to $4 trillion? Did I hear you right?

Mr. JOHNSON. Yes, sir.

Chairman CONRAD. $3 to $4 trillion.

Mr. JOHNSON. Some of which would be provided, could be provided by the Federal Reserve; some of which would need to come out as, I think, a new budget appropriation on top of the full $700 billion for the——

Chairman CONRAD. And how much would you see—you know, we have had $700 billion in the Troubled Asset Relief Program. How much in addition to that would you view to be necessary from appropriated accounts?

Mr. JOHNSON. Well, I think it would depend on how much you are comfortable with the Fed, the role the Fed would play in this. I think if you could capitalize a vehicle with a total capital of, let us say, $500 billion and let the Fed leverage—provide the financing to leverage up the rest of it. Basically you are saying that there is a backstop from the taxpayer of $500 billion, and more capital will be provided if there are larger losses.

Chairman CONRAD. This $500 billion, if I can interrupt, would be on top of the $700 billion already provided?

Mr. JOHNSON. Well, as I understand the accounting of the $700 billion, there is about $320 billion left, although some of it was being spent this morning when I was coming in here, so I may not have the latest numbers on that. They say there is about 300 or slightly under 300 available there. I think I personally would take around about 100 for a housing refinance package, which leaves 200 from that. And then in the meantime——

Chairman CONRAD. Another $300 billion?

Mr. JOHNSON. Yes, another——

Chairman CONRAD. That is exactly the number I used yesterday in a meeting of Committee Chairmen, that we might well need another $300 billion, that we might expect the administration to come back to us in months with a request for another $300 billion.

Mr. JOHNSON. I think we are independently arriving at a very similar conclusion on that.

Chairman CONRAD. Yes. Dr. Setser, what is your assessment of what is needed? What kind of overall resources are needed for the financial sector alone? And if you want to comment on the housing sector as well, Dr. Johnson mentioned $100 billion for the housing sector. What is your assessment of what would be needed?

Mr. SETSER. I have not looked in detail at the housing sector, so I will refrain from commenting on a subject which I do not feel like I have the full expertise on. I think a lot depends on the size of the financial sector recapitalization, as Dr. Johnson mentioned, on how much of the refinancing for that comes from the Fed or comes from other vehicles as opposed to how much comes from the appro-

priated funds which are used to buy bad assets, the toxic debt, the original proposal of the TARP.

I think you probably need to remove a very substantial sum of bad assets off the balance sheet of the banks in addition to providing new capital on top of the capital that has already been provided, because I think you would likely want to buy those toxic assets at a level which is probably a little bit below the level that many banks hold those assets on their books.

Now, you can come up with creative ways of coming up with the financing for that large purchase of assets. Not all of it has to come from appropriated funds, although clearly, as Dr. Johnson mentioned, there needs to be a substantial pool of appropriated funds to provide the capital, the equity to backstop that facility.

And so I am thinking, you know, you would want to remove $1 to $2 trillion of bad assets off the books of the banks' balance sheets. I think that requires a rather substantial pool of resources to back it up, probably at the higher end of that.

Chairman CONRAD. OK. Let us say that it is the range that you have given, $1 to $2 trillion. How much capital would we need to deal with that level of problem? How much equity—and, obviously, the only place that equity is going to come from is here.

Mr. SETSER. My personal——

Chairman CONRAD. Twenty percent?

Mr. SETSER. I have not given that question the level of thought that I should. My personal preference would be to have more come from appropriated funds and less from the Fed, but I understand the constraints that exist. But I think that would be, to my mind, the better—the less leverage you use, the better. On the other hand, given the constraints on the use of taxpayer money, there is a strong incentive to make use of leverage.

Chairman CONRAD. So, Mr. Adams, what is your assessment?

Mr. ADAMS. I think that is absolutely right. If you allow the Fed to use its balance sheet and leverage to deal with probably the worst-case estimate, then you probably need $600 billion in appropriated funds. If we try to avoid using the Fed's balance sheet which is being used for a variety of purposes, and given what we heard from the Fed earlier this week, it will be used for even additional purposes going forward, then you will need to make up that difference with even more appropriated funds.

So, at a minimum, you are talking about $500 billion, probably, and north of there, depending on whether you want to do it straight up or through the Fed.

But you are absolutely right, we have to stabilize housing. Chairman Bair of the FDIC has had several great proposals initially costed out at about $50 billion. I assume that is more given the deterioration in the housing market. But until we stabilize housing, until we stabilize the banking sector, it is tough to do much of anything else. And I go back to your point earlier on the fiscal stimulus and repeat the phrase is "timely, temporary, and targeted." The key is composition, and the key is getting it out into the economy now. And only $170 billion of this package is actually spent in 2009.

Chairman CONRAD. Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman, and I thank the panel for sobering but very lucid comments here.

Let me pick up here. We basically have broken it into two issues here. One is the stimulus which is presently before us, and the other is the next event in this exercise, which will be an attempt to stabilize the financial balance sheets of our financial system, and that will involve, it sounds like in your estimates, a very significant new appropriations depending on how much gets leveraged by the Fed. And the Fed leveraging is essentially an expanding of the money supply, and they can do it. I mean, they can do $1 trillion. They can do $2 trillion. It is just a question of when that comes back to hit us as inflation, and certainly in the short run, that is not going to be a problem. But in the long run, that is always an issue.

So I guess my question is this: Since we have the stimulus sitting here, which is now up to almost—well, if you throw in interest, it is over $1 trillion. It is $1.2 trillion if you calculate the interest in the stimulus. Shouldn't we take some chunk of this, since it is sitting there right now ready to move, and move it over at least to address the housing issue, the $100 billion that Dr. Johnson was talking about, or some element of the housing issue to start taking pressure off that account which we know is at the core of the problem housing and financial system? And there are two or three good ideas out there that I have heard about, but I would be interested if you folks have additional ideas that we might be able to use stimulus funds for.

One is for the Federal Government to create a 4-percent, 30-year mortgage and open a window on that for 18 months, and we basically subsidize the difference between 4 percent and 5.5 percent, or whatever the rate is. And that costs us—I do not know how much, but I suspect it is less than $100 billion.

Another is to significantly expand tax credits to first-time buyers so that we create a huge incentive for the owner-occupant, for people to go out and buy a house and reduce inventory.

Another is to fund directly the FDIC initiatives in mortgage forbearance that historically FDIC has not been funded directly. They have always gotten—and they have a resistance philosophically over there to direct funding. But maybe it is time to put $40 billion in the FDIC for mortgage forbearance. It is my understanding that they would represent that a $40 billion funding would allow them to basically renegotiate upwards to 4 million loans which are on the verge of foreclosure.

I would like your comments on those three as options that we should maybe use the stimulus package money for, taking money away from, for lack of better words, what is in the stimulus now, which is long-term expenditures which should have gone through the appropriation accounts, and instead have basically been put in there because certain appropriators have an interest in those Government activities, and any other ideas you have. I will start with you, Dr. Johnson, because you specifically alluded that you had a series of ideas in the real estate area.

Mr. JOHNSON. Thank you. Yes, I think—let me take the second part of the question first, what to spend it on, and then I will come to how much should you take from the stimulus, if any.

I think, you know, your point about—your other point in your introduction about inflation is very important. We have to, you know, not take around the fact—off the fact that inflation can come back, and I think distortions in the credit market would play a role in that. And, you know, I think while the 4-percent, 30-year mortgage refinancing is appealing, it is hard to see that we necessarily exit from that very smoothly. Once the Government gets into subsidizing massive general credit programs like that, I worry down the road about inflation——

Senator GREGG. Well, I am talking about putting a hard sunset on it. You know, it takes 67 votes to extend the program at the end of 18 months.

Mr. JOHNSON. I think if it was a very hard sunset, the hardest that you can do, then perhaps that is worth——

Senator GREGG. A 100-percent vote.

[Laughter.]

Mr. JOHNSON. OK. But you understand, the point is that anything that gets the Government into the business of more permanently providing credit or underwriting credit I think is something that I would worry about. And I think that the FDIC initiatives scaled up to some degree—and I think there is also some good ideas there about how you use Fannie Mae and Freddie Mac, who do now work for the Government after all, and who do take over in the process when people default on assured mortgages, they take those mortgages out of the pool. They pay insurance to the holders of the securities. And then they have to deal with those mortgages, and they have to deal with those properties themselves. And you can, I think, take FDIC type ideas on forbearance and apply those to the mortgages that come in that fashion through Fannie Mae and Freddie Mac. Again, it is a question of spending some money, but $50 to $100 billion, I think, spent in this fashion would send a very powerful signal. And I think it would force us to get more deeply engaged with breaking this downward death spiral on house prices.

Now, as for whether you should take it out of the stimulus, you know, I honestly think $50 billion here or there, the current stimulus level, does not really matter. That is not going to be the decisive factor in whether the economy turns the corner anytime soon. But I think if you start scaling the stimulus down dramatically, that may send the wrong signal to——

Senator GREGG. I am not talking about scaling it down. I am talking about the same number and moving it over to the target real estate instead of the long-term issues of education or health care or whatever is in there that are traditional appropriated accounts.

Mr. JOHNSON. Personally, I would have preferred if the administration had come up with two separate initiatives so you could see very clearly there is a fiscal stimulus designed to target current spending and there is a housing piece designed to refinance mortgages. But given that that is not where we are, then I think I would be supportive of taking as part of the total fiscal stimulus amounts—let us say $50 billion—and finding ways to use that to restructure or refinance particularly problematic mortgages, the 2005-2007 vintages of subprime or Alt-A mortgages or ARM, ad-

justable rate mortgages that seem likely to move into foreclosure. At the moment, we wait for mortgages to—we wait for people to default, and then we try and figure out what we should do about it. Clearly, we should be getting ahead of that, including you need a program, a properly funded program to do that.

Senator GREGG. Dr. Setser, do you have any views on how to approach the stimulus and real estate?

Mr. SETSER. I do have some views on—unfortunately, I do not support moving funds out of the stimulus into this kind of initiative. I think that the process underway in the economy and the contractionary forces are such that you need to do both, and I am not in favor of reducing one to do more of the other.

Goldman Sachs has estimated that the adjustment on the private side of the economy, the balance between savings and investment, is going to be a contractionary force around 6 percent of GDP this year. And that is because savings is going up because of the fall in household wealth, and it is also because investment is going down.

I think that drag is so strong that you need to put money into the economy through the fiscal stimulus, and so I would prefer to see the housing stimulus done on top——

Senator GREGG. Well, if only 50 percent of the money on the stimulus on the appropriated accounts is going to get into the economy within the next 2 years, is that accomplishing the goal?

Mr. SETSER. The more money that could be injected into the economy, the more quickly, and the more effective the stimulus would be.

Senator GREGG. Thank you.

Mr. SETSER. On housing, I have—you know, I am probably the only person here who does not actually own a home, so I have a somewhat different view about falling home prices than those who do. And I would note that I think historically the problems that we got into have in some sense had to do with the fact that we tended to subsidize borrowing to buy homes as a part of the process of subsidizing homeownership. And so I would prefer initiatives that did not subsidize borrowing quite as much, and they found other ways to limit the scale of the losses to help people keep their homes. Some forms of loan modification are useful in that regard.

And then also I would note here—and this goes a little bit to the subject of the theme of this hearing—that the borrowing rate on the conforming mortgages has come down because the spread on conforming mortgages has come down because the agency bond spread has come down, and that is because of the signals that the Federal Reserve sent that it was going to buy up some of these agency bonds in the market. And what that actually did was it offset a move by China and other large central banks out of that portion of the market.

So I think we have seen a big fall in agency rates that will over time, without any additional appropriations, help to provide additional mortgage financing in the long end.

Senator GREGG. If you could make yours brief so that we do not tie up more time. I am sorry.

Mr. ADAMS. Yes, I support the 4 percent. I think CBO is trying to cost that out, and I look forward to that estimate.

Yes, I support the FDIC proposal, and, yes, I support the idea of taking some of those spend-out programs that do not kick in until 2012 and 2013, taking those funds and applying them to these programs.

Chairman CONRAD. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I have got a couple of questions about the financial structure, although one thing I share Senator Gregg's concern that we grapple with this real estate issue. My hope would be, as someone who somewhat reluctantly supported the second tranche of the TARP funds, there were some indications from the administration that they were going to be talking about that $80 to $100 billion into housing relief and foreclosure relief, and the sooner they get the details of that proposal out, I think the better.

I want to focus my approach on the banks. Thinking back to the Chairman holding up the Washington Post's chart from yesterday morning in the Business Section that had all of the banks, not just U.S.-based banks but all across the board, one of the things I am trying to sort through in my own mind is these banks have made, at least in retrospect, inappropriate decisions in some cases. We are looking at how we recapitalize them. And while I hate to see the decline in all these bank share prices, don't we have to in a sense let some of the balance of this equity wash its way out? Don't the existing equity holders have to continue to take some hits? So that we think about this recapitalization mostly being driven totally by the Government, there is an awful lot of money sitting on the sidelines right now in T-bills with not good returns. I hope that we think about not just a Government-only sponsored recapitalization, but how we get the private sector investors back in.

The first question is: Are there examples from around the world avoiding what I think we would all want to do, nationalization of the banks the way the U.K. has done with the RBS, that we can let the market work its way, continuing with the existing equity holders, somehow guarantee that interim period before we get the private sector investors, one, back to the table? And, second, so I can get both of my questions out, and then all of you can respond, we have been, again, thinking about this bad bank idea and how we get these toxic assets off the balance sheets. One of the things I have not heard discussed is, if we think about a lot of other traditional corporate entities who may have a bad line of business or a toxic asset on their balance sheet, oftentimes they will take it off their balance sheet, spin it off into a separate equity holding with separate shares of stocks, manage it themselves so the Government would not have to take it over. And if, for example, the Citi's and the B of A's rolled out their toxic assets into a bad bank that would be off balance sheet, that would have a separate corporate structure that they would retain some level of ownership in, wouldn't that free up at least the private side, then we might need some guarantee on those toxic assets? But wouldn't that also make it easier, again, for private sector resources to flow into the existing good bank now and not again have the Government end up owning, managing, and operating, which it does not do a very good, a bad bank? So in any order you would like.

Mr. JOHNSON. Senator Warner, I completely agree with the general sentiments you are expressing there, which is we need to get the private sector to invest in the banks, and obviously the existing equity holders have been largely wiped out. And as you say, there is plenty of money waiting on the sidelines. So private equity, for example, would be my leading candidate.

They will not come in, I do not think, until they feel both that the general macro economy, you know, is somewhat more clear, and also that the specter of nationalization is completely off the table. So they might have to feel the banking sector has turned the corner that they are not going to get wiped out. And I——

Senator WARNER. And, Dr. Johnson, does that mean, though, that we have to actually then—I do not want to take it to the absurd level, drive out all of the existing equity that are currently there before they will get that confidence level?

Mr. JOHNSON. No. No, you do not have to drive out all the existing equity, but the question is exactly this level of uncertainty around the toxic assets. So let us say you say to them come in now, you know, we, the Government, will help you find decent terms, and, you know, given the way these banks have been run, we will put a lot of pressure on through the regulators to sell. They are still going to worry about the liabilities they are taking over or their responsibility for these bad assets. And that is a tough problem to solve. You discussed a couple of ideas that I think would work in terms of splitting the balance sheet and providing some sort of backstop guarantee, so this was done in the Citigroup 2 deal in November before Thanksgiving. It was also done for UBS in January.

I think the scale of both deals was insufficient. They did not cover enough of the balance sheet, so it did not sufficiently reassure the market. Also, the macroeconomy has continued to turn down since then. But I think that is an approach——

Senator WARNER. Again, just a clarifying question. In both those cases, the banking institutions did not spin out those bad assets. While we guaranteed them, they did not spin them out into a separate entity that would then allow kind of a cleaner bank to——

Mr. JOHNSON. Right. That is hard to do because you are still—the creditors—you know, under existing—unless you can change the law quite quickly, the existing creditors have a claim on the good—you cannot say to them, OK, you get this, you now have a claim on the bad bank and not on the good bank. It is all intertwined. It is very complicated to split it in that fashion and to sort of remove—you have to use—this is where you are using the Government guarantee, so you are requiring the bank to take the first loss in both the Citigroup 2 deal and in the UBS deal that they did in Switzerland. And then the Government basically is going to have to absorb the rest of the losses.

Now, the problem with that deal is it is not very transparent. You do not know exactly what the value proposition is to the taxpayer there. And I personally would prefer more upside for the taxpayer, for example, in the form of recapitalization, the Government gets compensated with warrants. They cannot exercise those warrants themselves. They cannot get voting stock for the Government. But they can sell them to people who are on the sidelines

and, therefore, basically sell controlling stakes in these banks to other private parties. That I think would promote the right kind of restructuring and change of management that you would need at these banks.

Senator WARNER. Just to be clear again, so that if the Government came in with this recapitalization, they could then clear a secondary market of these securities so that private investors could come in and take the place of the Government?

Mr. JOHNSON. Exactly.

Senator WARNER. And then take the place of the Government—if there were no management controls in those shares, you would have to allow them then to convert into some level of management and oversight if the private sector came in. Is that right?

Mr. JOHNSON. Yes. So I think what we are talking about is ways to get a co-investment with the Government and the private sector when there is a real timing issue. The private equity wants to wait on the sidelines until deals are getting done and they can sort of see resolution of the banking sector problems. But, of course, you need to bring a few guys in early. So what is the right way to incentivize that? And what is the right way to make sure that the Government gets sufficient—the taxpayer gets sufficient upside?

Senator WARNER. Please, gentlemen.

Mr. SETSER. I think the key to bringing in private money is convincing private investors that there are not bad assets lying around on the bank's balance sheet, which they are putting—so that they limit the risk, so they are putting money in and they are going to get hit with a big loss on the existing bad assets. And there are a lot of different ways of accomplishing that goal, but almost all of them require the use of public financing.

I personally prefer those structures which fully remove the bad assets off the balance sheet. But then if you do that at a price that is appropriate for the taxpayers, you run the risk of leaving the remaining bank without sufficient equity. And then I think you have to find a structure which could involve private money for coming into the new bank that is left behind. But that new bank will also likely need some form of public sector recapitalization, the best I can judge.

Mr. ADAMS. Senator, I would recommend you probably have to do both, especially using a ring fencing insurance mechanism for whole loans, which it is much more difficult to value in price. So I was just using a combination.

I like the idea of taking the assets cleanly off the balance sheet so that private investors have at least a better sense of what they are getting. I agree with you there are tens of billions of dollars of private equity sitting on the sidelines ready to invest in financials. But the other issue, too, is the regulatory uncertainty. Congress this year will rewrite sweeping financial regulations. We do not know what that looks like.

So in some ways, you really do not even know what you are buying if you are going in and buying a financial now, and you do not know what kind of financial regulatory structure under which you are going to have to operate.

So sending early signals about the contours and composition of what a regulatory change might look like could remove some of that certainty.

Senator WARNER. I know my time has expired, but perhaps later one other question I would love to have goes into the real estate section. As we think about all of these mortgage modifications related issues, I would be interested—and, again, perhaps you can get back to me on this. The fact that we have taken these mortgage instruments and so sliced and diced them, so securitized them, so created all these ancillary obligations with the credit default swaps and all the other tools out there, doesn't that really make it dramatically harder, even if you have got the right program in place, to actually process the mortgage modification? Because you are going to be stuck with years of lawsuits unless you can do some major make-good.

Senator STABENOW [presiding]. And we will leave that answer for another time.

Senator GREGG. The answer is yes.

[Laughter.]

Senator STABENOW. Senator Alexander.

Senator ALEXANDER. Thank you, Madam Chairman. Thank you all for coming. I have two questions, and I will state them first and then make a little preference.

First, shouldn't we really be doing all this at once—housing, banks, stimulus—so we can see the whole picture and how much we are being asked to appropriate from the tax payers? And, second, are there any lessons, since this is a global discussion, from the rest of the world about how large our debt level ought to go? What are the reasonable limits?

Now, let me make my preference. As I notice looking around the room here, every one of us used to deal with real money. In other words, we worked for the State government. We were either Governor or Speaker of the House or something else. And as I have looked at the stimulus package, it is just staggering to me. The State of Tennessee is about to get $4 billion from the Federal Government for this so-called stimulus package. If we got $4 million, we would consider that nice. If we got $40 million, that would require a 2-day meeting to discuss what to do with it. Four hundred millions is as much as a new State income tax would bring in, and the last Governor who suggested that got run up into the Smoky Mountains and no one would even have dinner with him.

This is $4 billion—$4 billion. And in the House, they just stuck in almost $100 billion over the next 2 years to increase the Federal Medicare match, which is bound to go into the baseline over the years. And if I am not mistaken, it is as much money as we spent on the entire appropriation for the new Part D Federal Medicare prescription drug program for all the seniors in America. This is a huge amount of money we are talking about.

Maybe it is just my old Governor background, but the idea of saying, well, we need a trillion dollars, and then just let us spend it with whatever comes to mind, just strikes me as very irresponsible. Especially when I hear all of you say, it seems to me, that inevitably we need to appropriate—that means raise taxes; that really means borrow money—so that we can properly capitalize

something to take the toxic assets out of the banks. That might be another four, five, six, seven, eight hundred billion dollars. You were really saying, Dr. Setser, as high as we could go and tolerate so that we do not use too much of the leverage of the Federal Reserve. And then there seems to be general agreement that we ought to do something effective about housing, and that might be another few hundred billion dollars.

So why should we not be thinking about this all at once? Two or three or four hundred billion dollars for housing, four, five, six, or seven hundred billion dollars for toxic assets, and then an amount for stimulus with some strict definition of what we mean by stimulus. And I think it would be helpful to us to learn also from you what lessons can we learn from the rest of the world about how high our debt level ought to be before people, as one of you said, start choking on the notion of buying treasury bonds.

Mr. ADAMS. Indeed, Senator, we should think about this in an integrated fashion, and if you want to address consumer confidence, which is now at an all-time low or the lowest since they have been tracking the numbers since 1967, there is a certain desire to want to have a shock-and-awe approach to it to at least get consumers' attention that, in fact, circumstances may change, and they may change soon.

So you are absolutely right, Senator. We should think about it in a comprehensive, integrated approach, and that is certainly what the new administration has indicated they want to do. And I would hope that over the next few days or week they roll out something that looks comprehensive.

Senator ALEXANDER. Well, we will have already borrowed a trillion dollars.

Mr. ADAMS. Yes, sir. That is why we need to stress that these things need to be looked at as pieces of a broader whole, and I think that is exactly what we are trying to do here today, Senator.

On your other question about how much is too much, well, we do not really know. Some of it is a function of near-term deficits, but it is also a function of your longer-term fiscal viability. We benefit from having the world's reserve currency. We benefit from having the gold standard bonds of fixed-income instruments, and that benefit accrues to us for a whole host of reasons. But there is nothing set in stone that that has to continue in perpetuity. We have to manage our resources in a very sober fashion, and what I am worried about is not the trillion-dollar deficit we will run this year, but our long-run fiscal outlook that will add trillions over the next 10 years and trillions between now and mid-century. And I think that is when markets begin to start pricing into expectations that our instruments are not as worthy as they once were. And people will probably continue to buy them, but at what level, at what price. And we will probably have to pay a higher return. We will probably have to bribe creditors to buy more of our debt. And I did say that we are going to choke on debt. The world is going to be flooded with treasuries over the next 24 months, and we have to hope that there are enough borrowers out there, enough creditors to lend us money.

Mr. SETSER. I think I understand the concerns about the scale of borrowing, but I would just note that we are dealing with an eco-

nomic contraction of unprecedented scale. We are dealing with a mortgage problem, excesses of, you know, numbers of underwater mortgages of unprecedented scale. And we are dealing with problems in our banking sector, not just the S&Ls or a portion of the banking sector, but the core of the banking sector of unprecedented scale.

International comparisons suggest that getting out of any of these combined crises are extraordinarily costly, and we should be cognizant of that. But I do not think there is an alternative, unfortunately.

When it comes to assessing the level of debt, it is a function of both the stock of debt, but also, obviously, the interest rate on the debt. Right now the interest rate has come down, so the projected interest costs for 2009 and 2010 are actually a little bit lower than they were in 2007 because of the large fall in the average interest rate on the debt stock.

I think you have to start to worry when the two start interacting in a way so that the stock is going up and the interest rate is going up, and you are facing ever rising interest costs.

Forty percent debt-to-GDP for most industrial countries does not raise a lot of concerns. Sixty percent for major industrial countries with a lot of credibility—and I think we remain such a country—does not generally raise a lot of concern. If you get to the 80 to 100 percent of debt-to-GDP ratio—and by here I mean marketable debt-to-GDP—I think you start to get into worries.

Senator ALEXANDER. Where are we today?

Mr. SETSER. Forty-something.

Mr. JOHNSON. Forty-one percent is the current estimate of private sector holdings of U.S. Government debt. The CBO says by the end of 2010, it will be 54 percent before the fiscal stimulus. I would guess you figure on 8 percent from the stimulus if it does not get out of hand, so that is 62 percent. Cleaning up financial systems around the world of this kind of scale or fiasco costs between 10 and 20 percent. That is in addition to net private holders of Government debt. So that pushes us close to 80 percent of GDP. Now, that is a high level of debt, without any question.

And I think to answer your question, Senator Alexander, we should be considering all these things together. We have to. I hope the administration is putting together ideas and proposals on how they use the TARP funding that will address the housing and maybe the financial sector issues at the same time. I do not think that is enough, and that was the discussion with Senator Conrad earlier. I think an additional appropriation will be necessary to deal with at least the financial sector problems, and perhaps the housing problems, depending on what approach you want to take. And I think you do need to consider it as an integrated whole, because it is just one level of Government debt, and it is one Government, one confidence in the Government, one credit rating, and that needs to be safeguarded. And, of course, I think—and this is the point Tim was making a moment ago—Social Security and Medicare reform becomes incredibly important in this context, because we have eaten up all the safety buffer that we had before. All the ability to sort of postpone resolution of those issues, it is gone.

Greece started, as I said before, with 90 percent of GDP, and I chose the example of Greece exactly because that is where the United States could end up, and that would not be a good place.

Senator ALEXANDER. Thank you.

Senator STABENOW. Thank you. I will take my turn at this point and then turn it to Senator Graham.

Thank you very much for very sobering statistics and information. I do want to start by just indicating to my friend from Tennessee that if Tennessee would like to forego the $4 billion they are receiving in the stimulus, the State of Michigan at 10.6 percent unemployment, and rising, would be happy to accept that. So we can maybe work something out there.

More broadly on the stimulus, I think it is important to say that the reality is our country, our Government should have acted sooner on the issues that are in front of us. I remember having conversations 2 years ago with extremely knowledgeable, credible people in the housing industry, raising red flags about what was happening in the subprime market, indicating that exactly what has happened would have happened if we did not act boldly. There were proposals. They were not supported. The actions were not taken. And we are where we are.

And so we are now at a point where there are not easy or good answers, and it is an incredibly difficult and a huge crisis that we are trying to work our way out of.

But I think it is also fair to say we have to do something different. The same philosophy that put us here will not get us out of here, in my opinion, which is why we are trying to do some things different. They may work—well, we certainly hope they work. I believe they will work. But it will not be perfect, probably. But we also I believe, need to act as quickly as possible to begin this because every day the numbers get worse and worse and worse, and inaction is not going to help.

So I would love to see us do it all at once. I think we have to look at the big picture. But given the fact that it does take time to do it, I would much prefer that we get going. And I certainly think that the people in this country want us to get going.

A couple of questions, more back to the good bank/bad bank. I know you have talked extensively about that. But I wonder. We have talked a lot about taking the toxic assets off of the books, creating the bad bank and so on. There are those who would argue that we should do the reverse: capitalize a good bank, and with a time limit. I understand the implications of that, but with some several-year time limit and that going that way rather than taking the bad assets off the books and then having to recapitalize the banks that are left, it is a different way of looking at it. And I have not really heard you specifically talk about that, whether or not that make sense to attempt the reverse and create a good bank rather than creating a bad bank.

I wonder if someone—Dr. Johnson?

Mr. JOHNSON. Sure, I can take that. Yes, I think there are a number of good ideas out there, and I think the whole idea is that we could get going quickly, by the way. I am not saying we should sit around for 3 months and discuss this. We need to act quickly.

We have been sitting around for 3 or 4 months, actually, and we have not made a lot of progress so far.

So I think you could think about putting capital into either new banks—you could charter banks, and you could charter them and sell them to the private sector, for example, if you felt that was an issue. Or you could find ways to put additional capital or to enable this strong—some of the strong local regional banks that do not have these problem assets, you could find ways to enable them to scale up their activities.

The problem is that you would still have these very large banks looming over the economy, and there would still be the question of what are you going to do about a Citigroup or potentially about a Bank of America. And until you address that issue, there is a systemwide concern with regard to financial markets and the financing of business. And there is a budget concern also. So who is going to pay for the clean-up of those banks eventually?

And the market is quite good at this kind of the logic where they say, well, nothing is happening, it is going to get worse, and then they are going to nationalize. Unless you show them there is—I think nationalization would be a disaster in this country. I really do not think that is the way you want to go. But unless you show the financial market there is a credible alternative for dealing with the problems, yes, you can say, look—if you wanted to, you could say we will try and get more of the new lending out through other channels, but we also have a strategy for dealing with these existing banks. We are not just going to pretend they are not there. I think as long as you do not lose sight of that, then various approached would be fine.

Senator STABENOW. OK. Dr. Setser?

Mr. SETSER. I generally agree. I think the core advantage of putting—on the assumption that we put capital into all banks, including the existing banks with bad assets that would need large sums of additional capital and would really recapitalize in a way that would be convincing and allow them to continue to lend, I think you are effectively saying that the Government would become the largest equity owner of several of the major banks in this country, which is a reasonable policy approach if you are willing to accept the consequences of that policy approach.

What it does not—it avoids having to set a price on the toxic assets because you are putting equity into the banks, the banks still keep the toxic assets on their books. That has the advantage of you do not have to figure out what the right price is. It has the disadvantage of no one knows what the price is, which tends to make it harder to get new capital into the banking system, and I think it runs the risk of creating a situation where those who are running these large banks with all these bad assets are going to just sit around and do nothing and hope everything gets better, because if everything gets better and they have marked the toxic assets down to some level, then they can get them—mark them back up, get a big profit. And, you know, if things get even worse, well, what is the worst that happens? Well, the Government puts in more money.

So it does not necessarily provide a resolution inside the banks on what to do with the toxic assets. So my guess is you need to do both.

Senator STABENOW. OK. And I do have one other question, but, Mr. Adams, did you want to comment on this?

Mr. ADAMS. No.

Senator STABENOW. All right. To followup on what Senator Gregg was talking about in terms of a proposal that we have heard in terms of low mortgage subsidizing of, you know, 4-percent, 30-year mortgages with a sizable tax credit for first-time homebuyers was the philosophy of saying rather than just focusing on mortgage foreclosure mitigation, but let's gets people buying houses again, let's get people who can buy houses to buy houses, and doing it that way.

I wonder if you might just speak a little bit more about that. I know, Dr. Johnson, you were saying you would be concerned about the long-term implications of the Government coming in and subsidizing interest rates and so on. But the idea of—rather than—and I know we need to do some of both, but not just focusing on foreclosure mitigation, but how do we get the general economy, the housing economy going again so that people who can purchase homes will purchase homes and we will start the economic activity around housing that we have been missing.

I wonder if any of you would comment on that. Mr. Adams?

Mr. ADAMS. Yes, Senator, I like the idea. I think it is bold, it is clean, it is broad-based, and I think it will prove effective. We do not know the costs, and we do not know the costs in pure budget terms, and there is a variety of ways of doing it. Again, the Fed could use their balance sheet. Someone will have to subsidize the difference between the market rate and whatever rate, 4, 4.5 percent. And I know this idea has been kicked around.

In fact, I think we need to make a threshold decision we are either going to do it or not do it because I think what you do is you paralyze a lot of buyers who are sitting on the sidelines thinking, well, I might go buy a home, but I am going to wait and see if this 4.5 percent thing materializes.

On the first-time homebuyers' tax credit, I think the problem is first-time homebuyers just cannot get access to credit, so even if they have a tax credit, first you have got to have someone who is willing to extend you credit to actually buy the home, to get the mortgage. And that is where the real problem is.

So I think we have got to unfreeze the financial system, and we can do that in a variety of ways. But I like the 4, 4.5 percent approach, and I like the FDIC approach of addressing the foreclosures and the wave of foreclosures we are going to experience throughout this year.

Senator STABENOW. Thank you.

Mr. JOHNSON. If I could just add one comment to that.

Senator STABENOW. Yes.

Mr. JOHNSON. When I worked at the IMF, the IMF was the custodian of fiscal prudence and warnings for lots of countries around the world. One of the big things that you would always warn governments about is getting too involved in the credit process.

Now, I take Senator Gregg's point that perhaps in the U.S. it is different. Perhaps the U.S. really can make this absolutely watertight in terms of any kind of influence or directed credit or, you know, various kinds of things that in 189 countries in the world this would go badly off track. But I do want to raise that flag and tell you it is extremely dangerous from that point of view. That is the international experience.

Senator STABENOW. Thank you very much.

Senator Graham.

Senator GRAHAM. Thank you. This is an amazing country where people like me will decide these things.

[Laughter.]

Senator GRAHAM. I mean, I say that very openly and honestly. The political system is better than the alternative, but as I sit here and listen about the different options and combinations, I am thinking as a politician, now what I sell people back home? Because this is not going to work forever. We have got probably one more shot at this.

The TARP, you were very brave, by the way. I voted for it the first time. Do you think the first $350 billion was wisely spent?

Mr. SETSER. I guess I will take that. It probably was not spent as well as it could have been, but I think we have to contemplate the consequences of not putting money into the banks. And I think the consequences of that, to be blunt, would have been the failure of several major institutions.

Senator GRAHAM. Dr. Johnson?

Mr. JOHNSON. No, I think the money was largely wasted. I think the support provided by the Federal Reserve to the financial system in September and October was decisive and excellent. I give them full marks. The TARP I money was largely wasted.

Senator GRAHAM. OK. Mr. Adams?

Mr. ADAMS. I think the money should have been used for what it was sold to be used——

Senator GRAHAM. Now, can I interrupt? That is the problem that I have got, is that I was told A and they did B. I think we need to investigate whether or not they were honest with us to begin with, because we are not going to do this a bunch more times. That is a technical term, but we are not going to do this a lot, because people are running out of trust and patience with us up here.

So I was told we are going to get these bad toxic debts off the books. That made sense to me. I did a news conference in South Carolina in front of a Fannie Mae house that was in foreclosure saying that we are going to buy this house and 1 day the economy is going to get better; the house will sell, and we will get some of our money back. The next thing I know, they are giving money to every bank in the country, some of them who do not even want it, and nothing much has happened. So we got a second chance at the next $350 billion.

So from the financial point of view, would you urge the new administration to take the next $350 and deal with the toxic asset problem or the housing problem?

Mr. JOHNSON. Well, my recommendation would be to do both, and I think—you have to recapitalize the banks, and I think that is what we were just discussing. But if you do not remove the toxic

assets, then the capital is going to be impaired right the get-go and the private sector will not come in and help you.

Senator GRAHAM. Well, see, that is what we need to know, because $350 billion will not allow you to do both. And we are going to get into this deal of, well, you spent $350 billion more, what the hell happened with it? So we need to let people—we need to make sort of a systematic approach to this. If you have got $350 billion that is going to be required to two things, not one, and it does not get you to where you want to go, we need to tell the people in America that $350 billion is not the solution.

It is sort of like political triage here. The $350 billion is best spent how, Dr. Johnson? If you had to pick, what would you do with the $350 billion?

Mr. JOHNSON. Well, as I said, I do not think you have $350 billion left. I think it is down to about $300 billion.

Senator GRAHAM. Three hundred, whatever number.

Mr. JOHNSON. I think that I would use $100 billion of that to capitalize a housing refinance scheme of the kind that we——

Senator GRAHAM. Do you all both agree with that?

Mr. ADAMS. Yes.

Senator GRAHAM. OK. So $100 billion of the $350 billion, this panel agrees should go into the people that are in foreclosure, right?

Mr. JOHNSON. That is right, foreclosure mitigation.

Senator GRAHAM. OK. Now, there is the other aspect of housing, the excess inventory. In 1974, we had a tax credit that allowed a lot of inventory back then to be washed out because people could use the tax credit to make a downpayment. Do you suggest we look at that component of it, trying to come up with a hook to get people to buy this excess inventory, a one-time good deal?

Mr. ADAMS. Yes, Senator. I do not know the budgetary costs of that particular program, but it is certainly worth looking at.

Senator GRAHAM. I think it is like $74 billion, but we are getting that scored.

And the third thing is the 4 percent. Now, the thing that attracts me to most of that is I think people really will like it, and they will like me.

[Laughter.]

Senator GRAHAM. And that is part of what we do up here, if we——

Chairman CONRAD. Senator, that is a stretch.

Senator GRAHAM. Yes.

[Laughter.]

Senator GRAHAM. Well, it is the closest they will ever to come to liking me. But the point is that from a political point of view, we have got to get people who have done it right to feel like they are getting something out of this. And you do not own a house, do you, Dr. Setser? My goal is to get you into a house. So if I had a 4-percent mortgage and I looked at the difference between what I owe on my current mortgage and 4 percent, that would be hundreds of dollars a month that I would have. If you repeat that a million times over, that helps the economy doesn't it? I mean, that just does not help housing. That is really freeing up a lot of money that

would be going into the mortgage banking system that hopefully could go into the general economy. So is it a two-fer?

Mr. ADAMS. It certainly will help household cash-flows, which are under stress, and will be more under stress as the year progresses. And it makes those assets, those homes, the value of those homes for the purpose of being on the balance sheet, the banks more viable and more accurate. So you are getting a two-fer.

Senator GRAHAM. So that is what I am going to tell people back home, not only by lowering your mortgage rate, that is good for you, it is good for the economy and it may address our bottom-line problem with the financial institutions more directly by having some of these assets.

Mr. SETSER. Let me, if I could add something, since I am the targeted audience for this 4 percent.

Senator GRAHAM. Yes, you are.

Mr. SETSER. I think what I would worry about is, you know, on one level it might make all of you a little bit too popular, in which case you would keep it on forever, and that would not make Dr. Johnson happy. But it would make me happy because then I would know that the price of the home was going to stay high forever.

Now, if it is going to go away, I think what I would worry about is I would still be buying at too high of a price because of the overhang, because I think, you know, frankly, home prices got too high relative to incomes. And I worry a little bit about policies that are directed at sustaining an unsustainably high level of home prices, fully knowing that if you keep home prices up, you help the banks.

Senator GRAHAM. Well, you have got to understand this: Everything we are doing, no one likes to do and it is unprecedented. I mean, if we are—that is no longer the test. There are things that the Federal Reserve is doing I never dreamed they would do. There are things I am voting for I never dreamed I would do.

So an 18-month window that would be a hard window makes sense to me. If we are going to treat this problem as a global financial crisis of historic proportions, I think Republicans and Democrats have to embrace things that we would never embrace before. And I do not like the idea of going into the marketplace and setting a Federal Government rate. That bothers me greatly. But it does seem to generate some solutions to more than just the housing problem. It seems to create a stimulus effect of its own by giving people more disposable income. It seems to migrate to the banking problem, to the financial institution problems. It seems to have a reach far beyond just making me popular. And I am being very serious about that. It seems to be able to connect the dots on many of these problems, but by itself is not enough.

Dr. Johnson?

Mr. JOHNSON. A couple things. Sorry to be a little negative.

Senator GRAHAM. That is all right.

Mr. JOHNSON. Because it seems to be going in a direction, an attractive direction or you, but two things.

First of all, close to 50 percent of all refinanced mortgages or mortgage that are rescheduled by the lender, close to 50 percent of them go into default within a year. So there is a question of if you want to do a broad refinancing package, which is what you are

talking about, or do you want to have something take your limited dollars and use that in a more targeted way to deal with——

Senator GRAHAM. Well, you do both. I mean, the people that are in default, we have come up with ways to basically renegotiate your mortgage—and I know my time is up. Fifty-2 percent of those who got refinancing went back into default; 48 percent made it out. That is pretty good. I mean, I look at it as the glass half-full.

What I am talking about is people who are not in default, people like myself, people probably here at this table, that would take advantage of this one-time good deal. It would generate some revenue into the financial systems, and it would create some cash-flow for the American consumer that would help us down the road.

And I would just end with this note. When it comes to the financial institutions, I think the first $350 billion was wasted. And I do not know how you identify these toxic assets, but if we could do something like Senator Warner suggested where the Federal Government does not have to do it all by itself and take all the risk and get some of the capital off the sidelines, I think we would be well served in that financial part.

I would just end with this note. What I want to take from this hearing is go back to people in South Carolina and say that $350 billion was not well spent, the next $350 billion can be better spent, but it is not nearly enough; $850 billion can be rearranged, but probably at the end of the day, that is not enough.

Is that fair to say?

Mr. JOHNSON. That is fair.

Senator GRAHAM. Thanks.

Chairman CONRAD [presiding]. I would say to the Senator, I think this hearing has been very powerful, both about the seriousness of the challenge that we confront, that it is global, it is deep, it is worsening, and that we are going to have to do far more, especially with respect to housing. And the question is: Where are those resources going to come from? And we are going to have to do far more about the financial sector.

There is simply no way to have full economic recovery when housing continues on a downward trajectory, especially at this rate, and certainly it cannot happen without the financial sector being strengthened. All of the models that talk about job generation are based on the concept of a basically healthy financial sector, and we do not have that. And somehow it has got to be restored, and obviously, based on this hearing, it is linked to dealing with the toxic assets, isolating them in some way, and clearly we need the multiplier effect of Government funds unlocking private funds to help us lift this boat. And I think that is the clear message from this hearing from all of our witnesses that housing has got to be better addressed, that the financial sector has certainly got to be better addressed, and it is going to require hundreds of billions of dollars over and above what has been so far allocated.

Senator Whitehouse.

Senator WHITEHOUSE. Mr. Chairman, let me make one quick point and then ask a question that follows up on what Senator Graham was getting at.

The quick point is that my office has calculated that the Bush administration has added nearly $8 trillion to the national debt

versus where the budget was planned to go the day he took office—$8 trillion. And nobody had a peep to say about that this entire time. I mean, you ask most Americans, they do not even know that that is the kind of damage that was done.

We are looking at a $50-plus trillion entitlement liability against which we have put zero, not a nickel; $35 trillion of that is Medicare alone. So as alarming as some of these numbers are—a trillion, 2 trillion, 3 trillion, 4 trillion—faced with the clear and present danger that we now have of global economic collapse, the idea that we would now nickel-and-dime over $3 or $4 trillion when we let Bush blow twice that, and when we have got more than 10 times that looming at us, most of it just in health care alone, you cannot have your priorities in sync if you feel that way. That is my point.

My question follows up on what Senator Graham was saying about in a democracy in particular, the economy and the polity connect. And public faith has to be maintained, or else this whole thing falls apart.

What experience do you all have with how governments did in other countries when there were these national economic wipeouts? In particular, if they were elected governments? And, in particular, if we got into situations where there was the widespread perception of scandal, of favoritism, and injustice? And I ask this question because I put two things in counterpoint.

We fought like the devil—and some people like Senator Stabenow fought as hard as she could—to try to support the American auto industry. And we are fighting over maybe $18 to $30 billion. The whole industry depended on that, and we had a huge colossal fight here about that.

The Wall Street Journal has reported that there is deferred executive compensation of the books of the Wall Street banks that are getting TARP money of $40 billion, and the woman who wrote that article says that that is a bottom-line number. If we are willing to put a whole industry at risk and we do not even have a means to look at $40 billion in deferred executive compensation, that if there were a bankruptcy would have been paid off at pennies on the dollar, because these banks have a public utility function, we cannot let that happen, so as a side bonus we are going to let their executives walk away with $40 billion? That kind of stuff I think puts us at very grave risk of a catastrophic loss of confidence in Government as the pain really begins to sink in and people's tolerance for this nonsense evaporates.

So I would love your thoughts on not just the economic part of this, but what does this do to governments?

Mr. JOHNSON. I think that I agree very much with the sentiments that you are expressing, Senator, and I think you are exactly right. What we typically see when a country gets into a crisis and tries to engineer or reform its way out of it in various ways is various kinds of scandals pop up, and this is, you know, the case in Eastern Europe, it is the case in Western Europe, pretty much all around the world. And these scandals, you know, really touch a nerve because public money in some form is wasted. Maybe the amount of money that has been wasted is small relative to the total endeavor, but it really, really annoys people and bothers them, and

governments fall. Usually we are talking about a parliamentary system of some kind so the government can fall and a new government can come in. And I would say that scandal-generated government turnover is the No. 1 or No. 2 cause of governments falling in these kinds of situations.

So I think you obviously have a rather different system of government here. The Government cannot fall in the same way. But you can have an enormous amount of——

Senator WHITEHOUSE. Every 2 years it can.

Mr. JOHNSON. Good point. But in the meantime, you can have an enormous amount of political and social backlash, and you can have a great loss of confidence in the Government. You know, to be honest, that is one reason I worry about this 4-percent mortgage refinancing deal. So that is a nice deal to make people very popular, but if you start to see any kind of scandals coming out in and around—I am not sure what dimension of that program, you could see how the whole thing would start to feel, you know, pretty negative for a lot of people.

Senator WHITEHOUSE. Dr. Setser?

Mr. SETSER. Well, I read, I guess yesterday, that Wall Street paid out the sixth highest level of discretionary bonuses in its history, and it clearly did not have its sixth best year in history. The fact that some strong understanding was not reached with the banks at the time when equity was given to those banks, particularly those banks that were in the deepest trouble, which were known, that they would not significantly reduce the amount of discretionary bonuses, reduce dividends, take their own internal resources and use those resources toward recapitalization, was, I think, a tremendous mistake.

And when I say that I think the $350 billion was used necessarily, I think it was used in a way that was necessary given the fact there was not enough money to do what was originally proposed, which was use the appropriated funds to buy the toxic assets off the banks. You could not buy them at a price that would leave the banking system solvent and buy enough of them with $700 billion. So you were left choosing between bad options.

I think the challenge now is to provide a big enough frame of reference, of resources, so that you can actually do what is needed, and what actually is needed, you need to sort of go through the banks, force them to value their assets at a realistic level. Those banks that do not pass necessary capital requirements and cannot get additional capital in the market at that level will have to be provided, taken under the public wing, and other banks will be recapitalized, and the bad assets will be moved off the balance sheet.

Senator WHITEHOUSE. You are back on to the economic question. My question to the panel was about what happens to governments when there is scandal in all of this and what is the experience. If you have something to say to say to that, I would love to hear it. If not, I would love to hear from the next witness.

Mr. SETSER. Let me just note that in many countries a democratic election which installed a new government provided the basis for the recovery. Think of Korea in 1998 when the election of a new President, President Kim Dae Jung, allowed Korea to move on from the past to focus on what needed to be done. And then it ulti-

mately hinges on whether the new recovery program works. If it does not, then——

Senator WHITEHOUSE. New government.

Mr. SETSER. New government.

Mr. ADAMS. Senator, you tend to have social and political turmoil. Just pick up the paper today, yesterday, the day before. Eastern Europe, Central Europe, Iceland has a new government today because of the financial crisis that they have endured. We have seen social unrest in Russia and China. And there are thousands of other incidents that do not make the with post every. So indeed, we are seeing it, and I submit we are going to see more of it over the coming year, which has implications for U.S. foreign policy as well.

Back to State, it goes without saying that there has been excessive compensation. The market will take care of some of that. Guidelines from Congress will take care of some of that. The industry itself has come up with a set of self-regulatory standards which I think will address it. And I know there is some response on Wall Street, well, maybe we will lose some of this talent. That is fine. Maybe they will become teachers and engineers and doctors.

Senator SANDERS. Talent. Did you say talent? Some of the genuses who got us to where we are today, we may lose those guys? OK. I just wanted to be clear.

[Laughter.]

Senator WHITEHOUSE. Mr. Chairman, I would like to make one observation off of this, and that is that if we look at government, writ large, basically there is stuff that government should never do. And then there is stuff that government can do within its authority, constitutional, statutory.

There is a big range of government power that we can only deploy if the person who it is operating on has the right to a due process hearing. All the way back to Mrs. Fuentes and her stove in the Supreme Court case of Fuentes v. Shevin. Because we do not have bankruptcy eligible in these areas because of the public utility aspect of all of this, and because we have not built an alternative judicial or quasi-judicial place to get these determinations made, what we have done as a country is unilaterally disarmed all of the powers of government that bear on these individual property rights, and we right now are in incapable, literally, except by persuasion—we can get our colleague Carl Levin to lean on Tim Geithner, to lean on Citigroup to junk their $50 million French luxury jet that they were buying. But you cannot win this battle waiting for one thing at a time to pop up and then leaning on people. We simply do not have the structure now to address what I believe are going to be socially disabling injustices in this system as we stand. And I appreciate the extra time to make that point.

Chairman CONRAD. Let me just add, I think it is important. There was reference to the first $350 billion by Senator Graham, and I did not want to let this hearing go by without saying my own view. If the first $350 billion had not gone out, I believe the financial system would be in collapse today. I believe the Dow would probably be at about 4000. So while I do not think it was deployed in the most efficacious way, I believe—there is no question in my mind, and the testimony before this Committee yesterday was very

clear on this point. Without that first $350 billion, the financial sector would have collapsed. And I think that needs to be on the record.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

Several of you alluded to the choice of using appropriated money versus having the Fed finance the additional capitalization of our financial sector. And I want to get a little clearer sense of the advantages and disadvantages of those two approaches, if any of you could comment on that.

Mr. JOHNSON. Sure. I think the point we talked about earlier in terms of the capital you need for one of these financial transactions. So there is some money—if you have a housing refinance scheme, I think that will be leveraged using access to the Fed in some form, and I think you do the same thing with the approach to the banking system.

You have to engage in a level of nominal transactions, the amount of mortgages being refinanced, for example, that is substantially in excess of what you could lose in any——

Senator MERKLEY. Yes, and I was referring to the financial sector. I assume this was the recapitalization of the banks that was being referred to in terms of additional appropriations versus using the Fed. And I assume by the Fed, we are talking about the Fed lending directly into the banks. But if you want to add any kind of description of how that exactly would work, that would be helpful.

Mr. JOHNSON. Yes, I think you would have the Fed—you would have the Government set up an organization like the Resolution Trust Corporation of the 1980's, and the Fed would lend—so it is a Government-owned corporation. The Fed would be lending to a Government-owned corporation, which is a completely safe loan. And that will provide you with a level of nominal transactionability for this RTC that you would need in the bank recapitalization and the toxic asset removal.

So if you buy toxic assets at market prices, which is what I would strongly advocate in this situation—I think it is completely doable, and the only thing that is fair to the taxpayer—then you should expect to lose some money on some and make money on others. The total amount of loss would be far less than the amount of money needed to buy those toxic assets from the financial system. So, therefore, it is fair to capitalize this organization at some safe level, so cover the level of losses that you and the CBO think could be incurred, and then use Fed lending to this entity in order to scale up the operations.

Senator MERKLEY. Do you picture in that—what type of interest rate exists between the Fed and this Government entity in that type of situation?

Mr. JOHNSON. Well, I think that is a very interesting question. Of course, you are just transferred from one branch of Government to the other, and you obviously have a say over what the Fed does with its profits ultimately, anyway. So I think that you would be lending at something close to the rate at which the Government—the Government entity would be able to borrow at a rate close to what the Treasury can borrow at. Essentially, it is a form of Treas-

ury borrowing, but from the Fed in this instance rather than from the public.

Senator MERKLEY. Anyone else want to jump in on this?

Mr. SETSER. I would be interested in Dr. Johnson's reactions to this since I can take this an opportunity to learn as well as to pontificate. But, you know, I think the Fed already has extended a very large amount of credit to the financial sector, so you can envision a world where, in effect—and that is being lent to a financial sector that has bad assets on its balance sheets to intermingle with some good assets. We are talking a sum in like the trillions of Fed credit to the financial sector.

If the Fed, in effect, shifts from financing——

Senator MERKLEY. Can I clarify that? That is really lent at the Fed rate, which has been close to zero. Is that correct?

Mr. SETSER. It would have been lent at a little bit higher rate than that because it would have been lent against a range of assets. It would not necessarily be zero, but at very low rates, yes. And, you know, it would be lending to the Government presumably at a fairly low rate. The RTC entity. But if you can envision a world where, in effect, the Government ends up buying the bad assets and some of the credit that the Fed has extended to the financial sector to support those bad assets now is now extended to this RTC-type entity, and so, in effect, it allows the Fed to exit from its existing bad loans, and so there is not a huge net extension of Fed lending.

Now, personally I would prefer to do it in as clean a way as possible with the least amount of embedded leverage on the Government's balance sheet as is possible, so to have more from appropriated funds and less from the Fed, because I think it is just more honest. But I understand the constraints that lead you to, in effect, set up an institution to go out in this case and borrow from the Fed.

Senator MERKLEY. So in the absence of political issues, you are saying that it would be much better policy to have a direct appropriation to fund such an entity.

Mr. SETSER. That would be my view, yes.

Senator MERKLEY. Do you share that, Mr. Adams?

Mr. ADAMS. Well, Senator, I think there is certainly a limit to how much the Fed can expand its balance sheet without causing concern, both near term and long term, as to what the effect is going to be. Are we simply going to inflate our way out of this by printing money? And if we are, that has implications for debt holdings around the world, our ability to issue new debt, and has implications for our currency.

So I think it is imperative for the Fed to think about what that limit might look like, although I am not sure it is knowable until you get there. And then how do we optimize the amount of room left given all the other missions that the Fed has decided they are going to take on, and some of it articulated in the Fed minutes just of 2 days ago.

So you could use some of this appropriated money to cover the credit risk, the cost of credit defaults, because the Fed cannot take credit risk, and allow the Fed to use its balance sheet to leverage up. It is one way of doing it.

The other is the way Dr. Setser noted, which is a full, front-on appropriation. It is just a function of how much you think the world is going to tolerate an expanded Fed balance sheet.

Senator MERKLEY. Well, and in that context, a number of years ago Warren Buffett announced that he was moving a lot of his assets into foreign currency because of the anticipation of a potential run on the dollar. And right now the dollar is stronger in part because the rest of the world is ailing along with us. But is there a risk here that we are expanding our monetary policy in a way which means when the rest of the world recovers that we might be much closer to such a potential run, countries decided not to hold the dollar as reserve currency? Or is this a risk that you feel is pretty remote? And maybe just real short answers because I want to slip in one more question before my time runs out if I can.

Mr. SETSER. I would start to worry much more about that risk when the current account deficit starts to expand. Right now I think the current account deficit is coming down. But should the current account deficit expand, resume its expansion as it was before, not contract, and the Fed be rapidly expanding its balance sheet and interest rates in the U.S. be very low, that would be a set of circumstances where I would start to worry.

Mr. ADAMS. Senator, we should comport ourselves in a way to minimize the potential downsides to our currency, both short term and long term.

Mr. JOHNSON. I think the dollar is heading toward a depreciation for the reasons you are alluding to, and I am not as worried about it as I think you are.

Senator MERKLEY. OK. I wanted to—and, Mr. Johnson, I wanted to direct this to you because of your concern about the 4 percent. I once ready a study that analyzed the 4-percent loans to veterans coming back from World War II, and it said it was probably the most cost-effective investment this Government ever made for a host of reasons—because of the fact that it stabilized families, created a financial foundation from which those families succeeded. Those families then proceeded to spend a lot of money repairing their houses, so on and so forth. And so there is kind of a precedent for the Government getting involved in lending or setting a price on lending.

So I wondered perhaps if you could expand on this. Now here I am thinking about the fact we are talking about the Fed lending what I think may come into the trillions directly into the financial world and maybe something less than a trillion through a Government entity. Why not have the Fed investing and lending directly to homeowners and stabilizing those homeowners, having the upside on the demand for products within our economy and so forth? I am trying to get a little better sense of your concern on this.

Mr. JOHNSON. Obviously, the U.S. Government has been involved in the housing market, in effect, and the cost of housing for a very long time. The program you mention is a good example. Fannie Mae and Freddie Mac, of course, are exactly designed with the sort of Government backing to keep the costs of borrowing down for people up to a certain level of mortgage.

The problem is, I think, with all of these programs that they are very hard to contain and control. Targeting the veterans after

World War II, that is clearly a self-limiting group of people because the veterans come back and that is it. Right?

The problem would be in 18 months, I think the economy might be starting to recover. Things, you know—we see green shoes throughout the world economy, and then people—and the program, of course, will be popular because you are putting money in people's pockets. How could you possibly withdraw it at that point? The potential for it to become open-ended and for—I have absolutely no problem with the Government supporting the economy in various standard and innovative ways right now. But what worries me is if you open the door to a big, never-ending commitment or entitlement, a new kind of entitlement program, then I think that is very difficult and very dangerous, and I hope you go there with some trepidation.

Senator MERKLEY. Thank you all for your expertise and your insights. My time has expired, Mr. Chair. Thank you.

Senator SANDERS [presiding]. Thank you. Senator Conrad had to leave, so I will be chairing this for a little while.

Let me begin. The title of this hearing is "The Global Economy: Outlook, Risks, and Implications for Policy." Before I ask you questions about the financial bailout and the crisis on Wall Street, let me ask your comments on another issue.

Compared to many other major industrialized countries, we do a pretty bad job in protecting the needs of ordinary people. Among other things, we have the highest poverty rate among industrialized nations. Certainly 18 percent of our kids are living in poverty. We have the highest infant mortality rate. We have the largest gap between the very rich and everybody else. The top one-tenth of 1 percent earn more income than the bottom 50 percent. We are the only Nation in the industrialized world not to guarantee health care for all people. Our people work the longest hours of any other people in the world. We surpassed Japan a while ago. There are jobs out there now which provide zero vacation time for people.

So in terms of when a major economic crisis comes, somebody loses their job today, they are losing their health care, given the fact that we have done such a poor job in protecting the needs of working families and children, are other countries in some ways better prepared to deal with a severe economic downturn than we are? Dr. Johnson?

Mr. JOHNSON. Yes, almost all other industrialized countries are better prepared. And it is interesting that we have to go through a discussion of a discretionary stimulus to provide additional forms of support, and I hope that is part of what will end up in the final stimulus package, addressing the kinds of issues you are talking about. In most other countries, that is part of what they call the automatic stabilizers. So that if you take France or Sweden or even the U.K., when the economy turns down and people lose their jobs, these additional benefits are available.

Now, you can question if they are sufficient. I would not want to give you the impression that poor people get off easily and that this is not a terrible tragedy throughout the industrialized countries. But the countries that have the same sort of problems that we are talking about here are more emerging markets. They are

countries that are at a half or a third of our income level, where, you know, people do not even register to be unemployed because there are no benefits that come with that, and they just have to go live with family members or find some sort of survival strategy.

So I think you are right to identify this as a substantial problem, particularly if we think this is not a 6-month recession. If it is a V-shape—I think this is one reason why the officials are staying on the side of this optimistic view. If it is a V-shape recession, you do not have to worry too much because the jobs will come back. But if it is a U or if it is something longer lasting, then these are going to be first order of problems that have to be confronted, just as they had to be confronted in the 1930's.

Senator SANDERS. Any other comments? Dr. Setser?

Mr. SETSER. I will just second what Dr. Johnson said.

Senator SANDERS. I apologize for being late, but I have not yet learned how to be in three places at the same time. There is legislation we are working on. But let me ask you this: My understanding is that we have spent $350 billion on the first bailout. We have authorized the expenditure of another $350 billion. I gather all of you are in agreement that more money is going to have to go to the Treasury. I should point out I voted against both of those bailouts for a variety of reasons.

And then, as I understand it, the Fed now has already lent out over $2 trillion. Does that sound right? And some of you at least were suggesting that the Fed may be asked to lend out or should be in a position to lend out many trillions more. Is that correct?

Mr. JOHNSON. Yes.

Senator SANDERS. Now, I have a car, an old Saturn, which I think I paid $12,000 for 5 years ago. And if I go to my mechanic today and the guys says, "Well, you know, Bernie, your car is in pretty bad shape. It is going to cost you $10,000 to repair your $12,000 car," I would say, "Well, let's junk it. I am going to get a new car.

At what point, how much money do you throw down a rat hole before you say, wait a second, maybe it is a good idea to do something radically different? I think Mr. Merkley was talking about a moment ago using some of this money to provide low-interest housing loans all over this country. I mean, if we took $3 trillion, you could rebuild America in a very substantial way. Why should we put $3 trillion more into an institution which has been corrupt, dishonest, reckless, immoral? Is that what we have to say to the American people? Dr. Johnson?

Mr. JOHNSON. Well, I think you are asking a very good question, Senator. And I think one way to think about it would be exactly to say at what point would you be willing to nationalize the banking system of the United States. And that would be a totally—and by the way, in many other countries, industrialized countries, that is exactly what they would do at this stage of the game.

Now I happen to think in the United States that would not go very well. But while I share, I think, and have spoken in public very similar sentiments to the ones you are expressing about the incompetence, and worse, the greed of Wall Street and the amount of damage that is done to us, I have also worked in a lot of coun-

tries around the world where the government has tried to run the banking system and it has not gone that well.

So we are between the devil and the deep blue sea here. And I think my inclination is we stick with the devil for a little bit longer. We kind of know how we operate and we think we can get a handle on it. I may be wrong. Perhaps we come back and debt-to-GDP is 80 percent and we are in a terrible global depression. Perhaps at that point we nationalize the banking system and I say that I was wrong and you were right.

I think my inclination, and Tim Geithner said yesterday, is we have had a private banking system for a long time in this country. It has kind of worked OK most of the time, we are trying to stick with it. I am supportive of that. But it is a risk. There is no question. It might go sadly wrong.

Perhaps we should be nationalizing at this point.

Senator SANDERS. I personally do not know what the answer is. But I think your average American is saying that—these are people losing their homes, their jobs, their health care. And they are saying oh, OK, we will give these crooks who have caused this crisis trillions of dollars more. That makes a lot of sense. That is a good thing to do. And by the way, of course, in one way or another, we are quite confident they will manage to get personal bonuses and their fancy yachts or whatever they get.

Yes, Dr. Johnson?

Mr. JOHNSON. So just to be clear, the schemes that I am proposing for recapitalizing the bank system would involve new owners and those new owners would almost certainly throw out the guys who got us into this trouble. I think wholesale change of the management of the major banks, to me, would be absolutely essential to moving forward.

But I do take your point that still people may not really understand this, they may not deeply—they may not appreciate what we are doing.

Senator SANDERS. Other comments on that?

Mr. SETSER. Well, we have gotten ourselves into as you, I think appropriately, described it, Senator, an enormous mess. And I think whenever the political system or the financial system has to sort out who takes losses, it is an ugly process. And there are, broadly speaking, three groups that can take losses: the people who lent money to the banks, the creditors, the depositors, money market funds, international bond holders. We tried that with Lehman and we made a policy decision afterwards that the consequences of that were so severe that we could not go forward with that.

Which leaves to groups: the equity holders and the taxpayers. The equity holders, I think, should take a very large hit. They have taken a significant hit. They probably should take more. If they sell their assets at a low price, that will happen.

And then you are left with only one group left. And while I fully support the general sense that the economy that we have had over the past eight or even longer years has not worked as well as it should, we also have this overhang of bad debt that we are going to have to deal with one way or another.

Senator SANDERS. Mr. Adams?

Mr. ADAMS. Senator, the American people should be outraged. I am outraged at what has transpired and the cost of fixing this program. Unfortunately, if we are going to have a vibrant world class economy, we need a vibrant world class financial sector. And I agree, we need to make a whole host of suggested changes to management. We need new leadership. I think we will get that. We have gotten it. We will get it more over time.

It is painful to watch the amount of money that we have got to spend in order to make it a vibrant system, I agree. But I think it is a necessary cost to ensure the economic viability of our country.

Senator SANDERS. You know, Dr. Setser, you used the word "We got into a mess." I do not think that is quite fair. We did not get into this mess. A relatively small number pushed us into this mess. And I think that what we are looking at may well be—you tell me, you know more about this than I do—the most, maybe since the Depression anyhow, clearly the most severe financial crisis that we have had.

And in truth, and again please correct me if I am wrong, this was really created by a pretty small number of people who were not content to make 15 or 20 percent a year. They had to make 40 percent a year. They were not content with earning $100 million, they have to earn $500 million. They were not content with having $1 billion, they need $3 billion.

You are not talking about millions of people. And I kind of resent sometimes the rhetoric that I hear from all over the place, "Well, we created this problem." No, we did not create this problem, frankly. You did not. I did not. A handful of people created, through excessive greed and dishonestly creating all of these esoteric financial tools which nobody understands. You have got trillions of dollars of credit defaults, swaps out there. No one knows what that means.

So I guess the concern is A, how do you hold these people accountable? And then I just have strong doubts about going back to a system which any way resembles the system that we had. And I understand all the reforms that people are talking about. I am just not even clear that that is enough.

And I take Dr. Johnson's point—the word nationalization, to me, does not frighten me. But I understand that the Government does not do things particularly well, as well.

So we have that difficulty of not trusting the people who have got us here, not trusting Government to do the right thing, and we have got to figure out way out of that.

Dr. Johnson?

Mr. JOHNSON. I think, Senator, one way to take your totally justified anger and channel it, if we are still working within the private banking system, is to think about breaking up the big banks. I actually think these big, global financial supermarkets are the buggy whip of our age. I think they are a great idea whose time has long passed and we should get rid of them.

And actually, I would suggest that when—if the Government comes in with capital, which I think it has to do, and the Government comes in with the right to determine who are the new controlling owners, I think you have to demand that—you should actu-

ally have some pretty strong antitrust provisions attached to that. Break up the banks.

I think we need a world class competitive banking system, as Tim Adams said. I do not think they have to be big banks. And they certainly should not be so big they can get us—"they" can get "us" into this much trouble.

Senator SANDERS. Thank you for raising that issue. When I opposed the first bailout, and I was on the floor, what I said was if an institution is too big to fail, then an institution is too big to exist. And that I think we have to take a very, very hard look at this.

But what is heartbreaking, and I spent 16 years in the House and two in the Senate, is I have heard these fierce debates. Some of us want to do something to help children get a decent early childhood education. And hours after hours of debate, $50 million, we cannot afford to do that. We cannot afford—right now on the floor of the House we are talking about a few billion dollars to provide health care for kids that do not have any health care. Oh, we cannot afford to do that.

And yet, we are glibly talking about trillions of dollars to do what? Is it going to build any homes, create any factories? It is to bail out an institution which has fallen apart because of the greed.

So if you do all that, what? We are back to where we were before. It is heartbreaking.

But I think, Dr. Johnson, your point about right now, you suggesting that we should end—right now, we should deal with this too big to fail by not allowing institutions to be too big to fail. Is that what you are saying?

Mr. JOHNSON. That is what I would make a condition. I am sure the Government is going to have to ultimately come in and recapitalize the banking system in some form or another. I think you should insist on that as a provision of that recapitalization, the breakup of these monsters.

I think too big to exist is a very good line and you should stick to that.

Senator SANDERS. OK. Any other comments that anyone wants to make?

Well, you have been here for a long time and we thank you very much. Thank you.

The hearing is adjourned.

[Whereupon, at 12:10 p.m., the Committee was adjourned.]

KEY ISSUES AND BUDGET OPTIONS FOR HEALTH REFORM

TUESDAY, FEBRUARY 10, 2009

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

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

Present: Senators Conrad, Wyden, Nelson, Stabenow, Whitehouse, Warner, Sessions, Bunning, and Alexander.

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

OPENING STATEMENT OF CHAIRMAN CONRAD

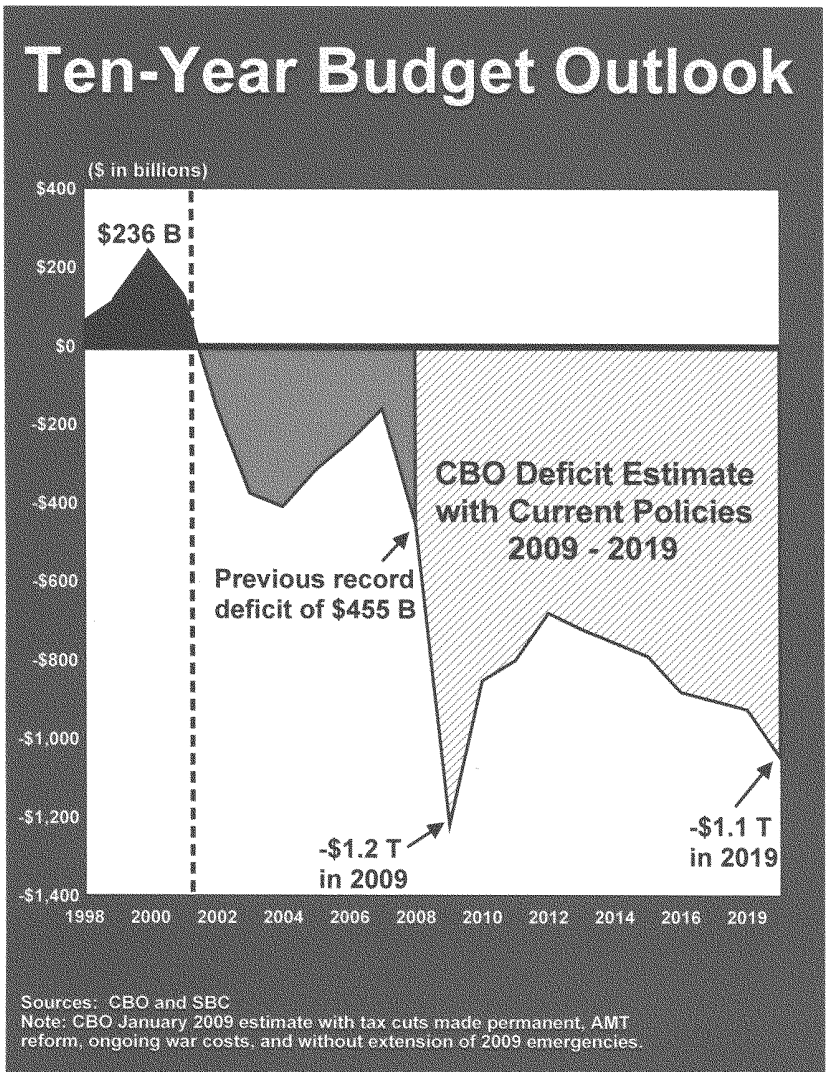
Chairman CONRAD. The hearing will come to order.

Senator Gregg is not going to be with us this morning, for obvious reasons. He is the President's designee to be the next Secretary of Commerce, and I want to say in this Committee what I have said elsewhere publicly, and that is that Senator Gregg's nomination to be the Commerce Secretary represents a great loss for the U.S. Senate and a great gain for the Obama administration. But it also represents a significant loss for this Committee. It is going to be very hard to replace Senator Gregg's knowledge, his understanding of economics, and his dedication to getting America back on track fiscally. And so when I heard the news, I had very mixed feelings. I thought the Obama administration is certainly doing itself a favor, but I will very much miss the partnership we have had on this Committee with Senator Gregg, and I think all members on both sides feel that same way.

This morning I want to welcome CBO Director Elmendorf back to the Budget Committee. Today's hearing will focus on health care reform. Specifically, we will examine some of the key issues and budget options that CBO presented in two reports on health care released last December. The reports represent the culmination of more than a year of work by the strengthened CBO health care team assembled by our former CBO Director, Dr. Orszag, who is now the Director of OMB. I want to commend the CBO staff for their outstanding work, and I want to thank Director Elmendorf for presenting the agency's findings to us today.

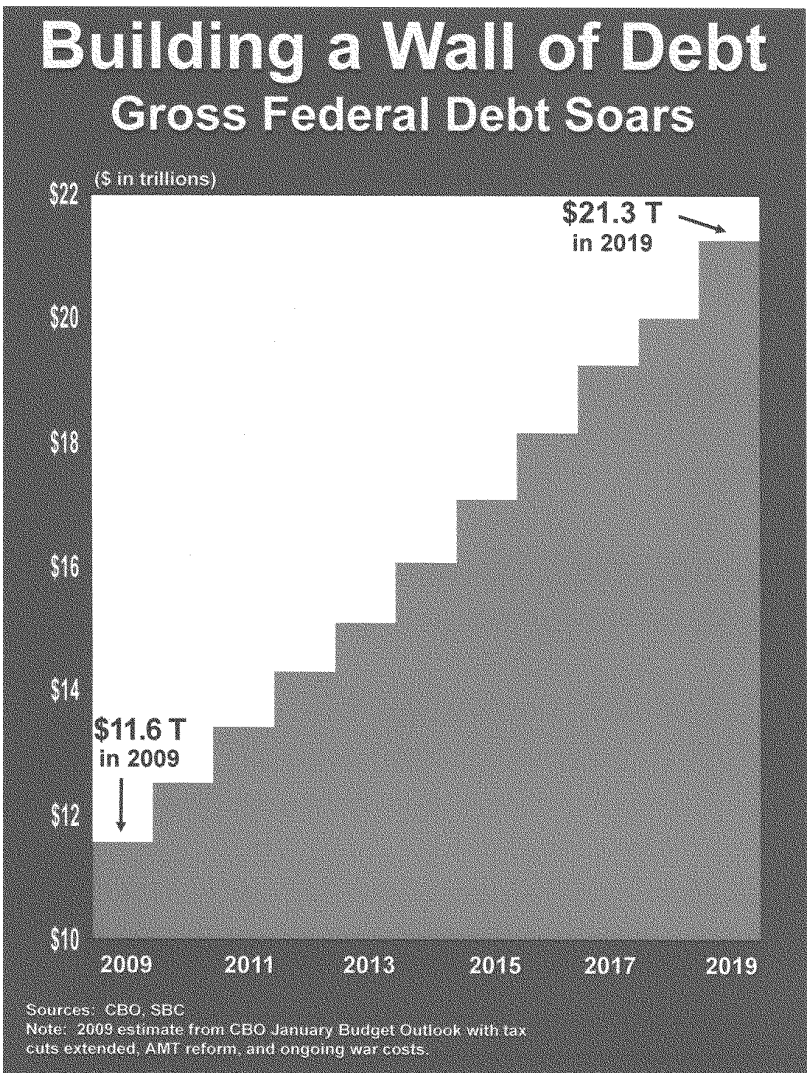
Let me begin by providing really a brief overview of the challenges that we face. The news that we received in January from CBO about the deficit was dramatic and serious. We face one of the worst budget forecasts that I have ever seen. CBO's estimate showed the deficit in 2009 would be approximately $1.2 trillion, and that is before any policy changes, before any economic recovery

package or other changes in policy. And, frankly, I have stated and I believe that that forecast itself is overly optimistic. And that is, I think, increasingly the conclusion of others as well, that this fall-off in the economy has intensified in the last several weeks. We saw in the January jobs number that nearly 600,000 people lost their jobs in the last month alone.

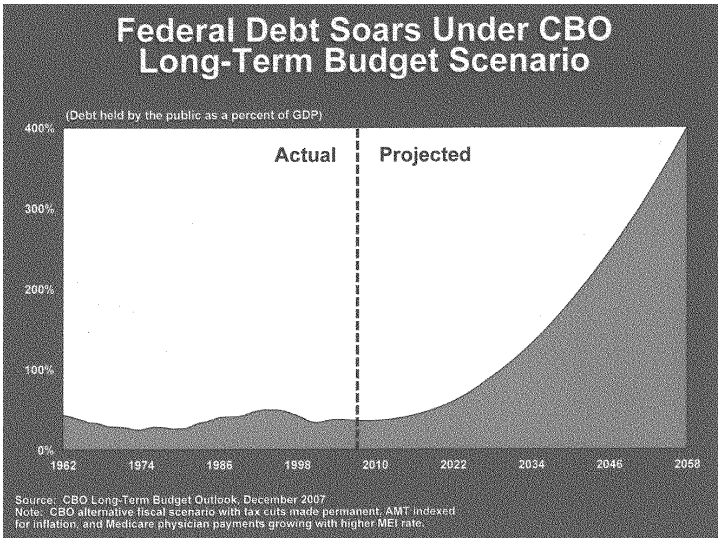


I have shown this chart many times because I think it is so important to make the point that we are building a wall of debt. The debt of the United States doubled over the last 8 years. It is set to, I believe, double again in the next 8 unless we change our long-term policy. I believe it is absolutely essential, once we have economic recovery underway, that we pivot and take on our long-term

imbalances, created largely by the entitlements but also contributed to by the revenue base.



Our long-term budget outlook is extremely serious. This is the Congressional Budget Office's long-term debt outlook as it was released in December of 2007. It shows just how serious our long-term outlook was before the current economic downturn and before adding in all of the Government's economic recovery measures. The combination of the retiring baby-boom generation, rising health care costs, and inadequate revenues is projected to absolutely explode Federal debt to more than 400 percent of GDP by 2058. That is completely unsustainable.

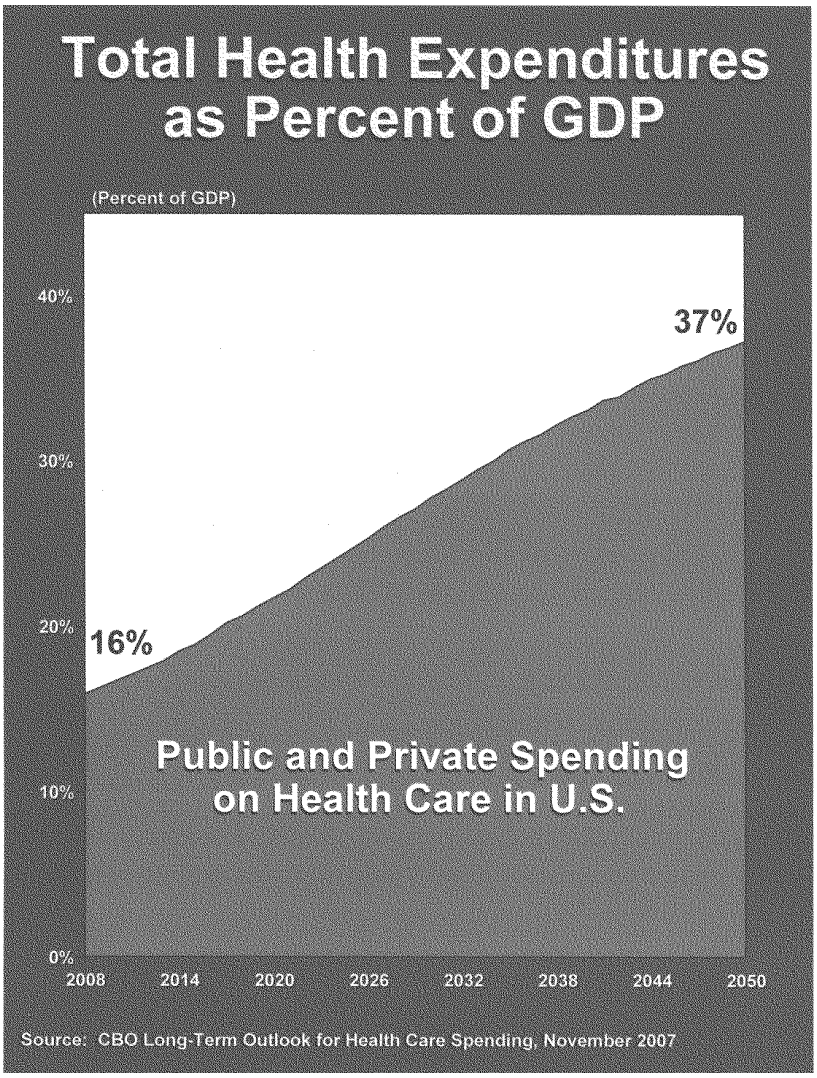


I hope colleagues in other committees, in other positions of responsibility—Jeff, why don't you come here? I am asking Senator Sessions to come and join me here.

Senator SESSIONS. Judd will not be here today?

Chairman CONRAD. Senator Gregg, as I announced earlier, will not be here today. Senator Sessions, as I understand it, will succeed him in the role of the Ranking Member of this Committee. We want to welcome Senator Sessions. It is a little bit premature to do it because Senator Gregg is still a member until his confirmation. But in anticipation of the change, I think it is appropriate that Senator Sessions sit in the Ranking Member's chair and participate. We appreciate very much his contributions to this Committee.

I was just making the point about how unsustainable our current budget trajectory is. There is not a single economist that I know that believes 400 percent of GDP as a debt level is tolerable. This is not just a demographic issue. Rising health care costs are exploding the cost of Federal health programs, and private sector health spending is also exploding. Taken together, public and private health care spending will reach 37 percent of GDP by 2050 if we stay on the current trend line.



Here are some of the key sources of growth in health care spending. There is limited evidence of what works and limited adherence to best practices. There is a lack of care coordination. Advances in medical technology, including prescription drugs, medical devices, diagnostic tools, and surgical procedures, are driving up costs. There is widespread geographic variation, sometimes as much as five times the usage for particular procedures in one part of the country versus another part, with absolutely no evidence that they get improved outcomes as a result. And there is an increased demand for health care with a higher prevalence of diseases like obesity and diabetes and more advertising directly to consumers. I cannot turn on the television without being bombarded with drug ads for various things. I was stunned—I guess maybe I should not

say I was stunned, but kind of taken aback. The other night I was watching, and they said you take this drug and the risk is death. And then they went through the drug, and they said there are some other problems with this, and another set of factors that might lead to death. And I thought,"Wow, you talk about a risk/reward ratio." I am not sure I would want to be taking that.

Sources of Growth in Health Care Spending

- Limited evidence on what works / best practices
- Lack of care coordination
- Advances in medical technology (drugs, devices, diagnostic tools, surgical procedures)
- Widespread geographic variation
- Increased demand for health care (higher prevalence of obesity, diabetes; advertising)

I am encouraged that we are beginning to address the sources of the growth in health care spending. The administration has made very clear that they want to tackle this problem. In fact, the economic recovery bill includes an important down payment on health care reform with investments in health information technology, comparative effectiveness research, and prevention and wellness efforts. But we all know it is going to take much more.

Downpayment on Health Reform in Economic Recovery Bill

- Health IT
- Comparative Effectiveness Research
- Prevention and Wellness

There are more steps that must be taken to truly bend the cost curves of health care. For example, the CBO reports identify a number of payment reforms that could be taken to slow the spending growth in Medicare and other Federal health programs: one, bundling payments for hospital and post-acute care to improve coordination; second, reducing Medicare payments to hospitals with high readmission rates; third, incentivizing physicians, hospitals, and other providers to better collaborate; fourth, using bonuses and penalties in Medicare to promote the use of health information technology; and, finally, setting payment benchmarks for Medicare Advantage plans equal to traditional Medicare.

CBO: Payment Reforms That Will Slow Spending Growth in Medicare

- Bundling payments for hospital and post-acute care to improve coordination
- Reducing Medicare payments to hospitals with high readmission rates
- Incentivizing physicians, hospitals, and other providers to better collaborate
- Using bonuses and penalties in Medicare to promote use of Health IT
- Setting payment benchmarks for Medicare Advantage plans equal to traditional Medicare

Source: CBO Budget Options, Volume 1, Health Care, December 2008

It is important to remember that making these reforms does not mean lowering the quality of health care. In fact, research suggests that some areas of the country that spend less on health care actually provide better health care. My own State is an example. We are in the top 5 percent in health care outcomes. We are at the very bottom in reimbursement. And interestingly enough, that is pretty consistently the case in Northern tier States. A study by Dr. Fisher at Dartmouth found that an astonishing 30 percent of health care spending may not contribute to better health care outcomes. That is a stunning calculation.

Here is what Dr. Fisher wrote in a health journal: "Although many Americans believe more medical care is better care, evidence indicates otherwise. Evidence suggests that States with higher Medicare spending levels actually provide lower-quality care. We may be wasting perhaps 30 percent of U.S. health care spending on medical care that does not appear to improve our health."

Thirty percent of U.S. health care spending translates into $700 billion a year. That is real money. We cannot eliminate all the unnecessary spending, but we have to try.

With that, I want to turn to Senator Sessions for any opening remarks he would want to make, and, again, I want to welcome him to the Ranking Member's chair, and at the appropriate time, when Senator Gregg has been confirmed, we will be able to make this all official.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman. I am pleased to be here, honored to have perhaps the opportunity to serve in this position. I have got to tell you, Judd Gregg was a great Chairman and a great Ranking Member, and you have been a great Ranking Member and a great Chairman. So I look forward to working with you in the way that the two of you have. You have not always

agreed on everything. We both have political pressures that we have to deal with. But, fundamentally, it is time for all of us to get together to work for the good of this country. And I know you are deeply committed to that, and the facts do not lie. You have been raising them over and over again. They speak for themselves, and we have got to do better.

This hearing I think is important, and I appreciate, Dr. Elmendorf, the work you have been doing so far, and the information that you have given us. This $52 trillion shortfall in Medicare and Medicaid over the next 75 years is something that requires real attention, and I appreciate the fact that, Dr. Elmendorf, you are starting now to think about what kind of policy changes may be out there, how you are going to score those so that when we make a decision, we will have good information on which to make that decision.

Thank you, Mr. Chairman. I turn it back to you.

Chairman CONRAD. Thank you, Senator Sessions.

One final point I want to make to the colleagues who are working on health care reform. I think they have got a heavy burden to carry to make the argument that we should add substantial costs to health care when we are already spending 16 percent of our gross domestic product in this country—that is $1 in every $7 in this economy—already in health care. That is nearly double most other industrialized countries. So those who advocate spending hundreds of billions of dollars more I think have a very heavy burden to carry. And I hope that message is heard outside this hearing room.

With that——

Senator SESSIONS. Mr. Chairman, could I just say, I had physicians up from Alabama yesterday and talked to a number of them. You know, they are small businesses. Several of them told me that. And I thought about one of the difficulties in this economy that we have all learned is uncertainty is very bad. So if they want to add a nurse or add a wing onto their clinic and the law says they are going to lose 20 percent of their reimbursement rate next year, that just confuses their whole system. And we know why we are not permanently fixing the Medicare reimbursement rate. We are not doing it because it scores at about $300 or $400 billion over the next 10 years. And so we just pretend that next year it is going to drop 20 percent, and it is not going to drop 20 percent.

I think that is a legitimate criticism of those of us in Congress. We ought to be able to at least tell them what they can expect to receive. As one of them said, "Don't call it 'reimbursement.' It is my pay, and you are talking about cutting my pay 20 percent next year." And we cannot do that. We are not going to do it.

So those are just some of the things that I think maybe the Budget Committee can contribute to working on.

Chairman CONRAD. Thank you very much.

Dr. Elmendorf, again, welcome back. Thanks again for taking this responsibility as Director of the Congressional Budget Office at this especially challenging time, and please proceed.

STATEMENT OF DOUGLAS W. ELMENDORF, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ELMENDORF. Thank you, Chairman Conrad, Senator Sessions, members of the Committee. I appreciate the invitation to testify this morning about the opportunities and challenges that the Congress faces in addressing two policy goals: expanding health insurance coverage and reforming the health care system to make it more efficient.

To assist the Congress in its deliberations on these topics, CBO has recently produced two major reports, as Chairman Conrad indicated. One, titled "Key Issues in Analyzing Health Insurance Proposals," examines the principal elements of reform plans that CBO believes would affect our estimates of the effect of those plans on insurance coverage, on Federal costs, and other outcomes. The companion volume, titled "Budget Options for Health Care," examines 115 discrete options to alter Federal programs, affect private insurance markets, or both.

Drawing on these reports, my testimony today makes four key points:

First, proposals could achieve near universal coverage by combining three key features: mechanisms for pooling risks, subsidies, and mandates or processes for facilitating enrollment.

Second, a substantial share of health spending contributes little, if anything, to the overall health of the Nation, as the Chairman pointed out. But reducing spending without also affecting spending that does improve health is challenging.

Third, despite these challenges, many analysts would concur with the importance of several approaches, including providing stronger incentives to cut costs and reward value, and generating and disseminating more information about the effectiveness of care.

Fourth, many steps that analysts would recommend might not yield substantial budget savings or reductions in national health spending within a 10-year window.

Let me discuss these points briefly in turn.

First, achieving near universal health insurance coverage would require three principal features. To start, mechanisms for pooling risks, both to ensure that people who develop health programs can find insurance, and to make sure that people do not wait until they are sick to get insurance coverage. Options for pool risks include strengthening the employment-based system, modifying the market for individually purchased insurance, or creating a new mechanism such as insurance exchanges.

Beyond pooling risks, achieving broader coverage requires subsidies to make health insurance less expensive for individuals and families, especially those with lower income who are most likely to be uninsured today. However, for reasons of equity and administrative feasibility, it is difficult for subsidy systems to avoid providing new subsidies to people who would buy insurance even without those subsidies.

In addition to pooling risks and subsidies, achieving broader coverage would require either an enforceable mandate to obtain insurance or an effective process to facilitate enrollment in a health plan. An enforceable mandate would generally have a greater effect

on coverage rates, but without meaningful subsidies, it could impose a very substantial burden on many people.

Without changes in policies, CBO estimates that the average number of non-elderly people who are uninsured will rise from more than 45 million this year to roughly 54 million a decade from now.

My second point was that a substantial share of spending on health contributes little to our health, but reducing this sort of spending without also affecting services that do affect health is difficult. As we all know, spending on health care has grown much faster than the overall economy for decades now, with studies attributing the bulk of that cost growth to improvements in medical treatments and technologies. This imposes an increasing burden on the Federal Government, as well as State governments and the private sector. The principal driver of the unsustainable Federal budget outlook, as the Chairman noted, is growth in per capita health costs, not population aging alone. And in the private sector, the growth of health costs has contributed importantly to slowed growth in wages because workers give up other forms of compensation to offset the rising costs of health insurance.

Third, there are a number of approaches for improving efficiency and controlling costs about which many analysts would probably concur. To start, many analysts would agree that payment systems should move away from a fee-for-service design and should instead provide stronger incentives to control costs and reward value.

A number of specific alternative approaches could be considered, including fixed payments per person, bonuses based on performance, or penalties for substandard care. But the precise effects of these alternatives are uncertain. Policymakers may thus want to test various options, for example, using demonstration programs in Medicare.

Many analysts would also agree that the current tax exclusion for employment-based health insurance which exempts most payments for such insurance from both income and payroll taxes dampens incentives for cost control because it is open-ended. Those incentives could be changed by replacing the tax exclusion or restructuring it in ways that would encourage workers to join health plans with higher cost-sharing requirements and tighter management of care.

Moreover, many analysts would agree that more information is needed about which treatments work best for which patients and about what quality of care is delivered by different doctors, hospitals, and other providers. But absent stronger incentives to improve efficiency, the effect of information alone on spending will generally be limited.

Fourth many steps the analysts would recommend might not yield substantial budget savings or reductions in national health spending within a 10-year window. There are several reasons for this. In some cases, savings materialize slowly because an initiative is phased in. For example, Medicare could reduce payments to hospitals that have a high rate of avoidable readmissions. But Medicare would have to gather information about readmission rates and notify hospitals before this approach could be implemented.

In other cases, initiatives that generate savings have costs to implement. For example, expanding the use of disease management can improve health and may be cost-effective, but may still not generate net spending reductions because the number of people who are receiving services is much larger than the number who would avoid expensive treatments later.

In still other cases, the Federal budget does not capture the reductions in national health spending. For example, if the Government provides a preventive service for free, national health spending might decline, but Federal spending might still rise because the Government would be paying for a lot of preventive services that would be administered anyway.

In other cases, incentives to reduce costs are lacking. For example, proposals to establish a medical home might have little impact on spending if the primary care physicians who coordinate care in such a system are not given financial incentives to economize on their patients' use of services.

And, last, for a wide range of possible reforms, limited evidence on the effects is available. Studies generally examine the effect of discrete policy changes, but typically do not address what would happen if several changes were made at the same time.

I began the testimony by referring to the opportunities and challenges that you face. I think the opportunity is that there is considerable consensus that we need patients and providers to have stronger incentives to control costs and that we need better information about the quality and value of the care that is provided. The challenge is that there is much less consensus among analysts about precisely which programmatic changes can move us most effectively in the direction of enhancing incentives and improving information.

Thank you. That concludes my prepared remarks. I am happy to take your questions.

[The prepared statement of Mr. Elmendorf follows:]

Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

Expanding Health Insurance Coverage and Controlling Costs for Health Care

before the
Committee on the Budget
United States Senate

February 10, 2009

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Tuesday, February 10, 2009. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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

Chairman Conrad, Senator Gregg, and Members of the Committee, thank you for inviting me to testify this morning about the opportunities and challenges that the Congress faces in pursuing two major policy goals: (1) expanding health insurance coverage, so that more Americans receive appropriate health care without undue financial burden, and (2) making the health care system more efficient, so that it can continue to improve Americans' health but at a lower cost in both the public and private sectors. Both are complex endeavors in their own right, and interactions and trade-offs between them may arise.

First, with respect to expanding health insurance coverage, my testimony makes the following key points:

- Without changes in policy, a substantial and growing number of people under age 65 will lack health insurance. The Congressional Budget Office (CBO) estimates that the average number of nonelderly people who are uninsured will rise from at least 45 million in 2009 to about 54 million in 2019. That projection is consistent with long-standing trends in coverage and largely reflects the expectation that health care costs and health insurance premiums will continue to rise faster than people's income—making health insurance more difficult to afford.

- Proposals could achieve near-universal health insurance coverage by combining three key features:

  - Mechanisms for pooling risks—both to ensure that people who develop health problems can find affordable coverage and to keep people from waiting until they are sick to sign up for insurance. Options include strengthening the current employment-based system, modifying the market for individually purchased insurance, and establishing a new mechanism such as an insurance exchange.

  - Subsidies to make health insurance less expensive for individuals and families, particularly those with lower income who are most likely to be uninsured today. For reasons of equity and administrative feasibility, however, it is difficult for subsidy systems to avoid "buying out the base"—that is, providing new subsidies to people who already have insurance or would have purchased it anyway.

  - Either an enforceable mandate for individuals to obtain insurance or an effective process to facilitate enrollment in a health plan. An enforceable mandate would generally have a greater effect on coverage rates, but without meaningful subsidies, it could impose a substantial burden on many people—given the cost of health insurance relative to the financial means of most uninsured individuals.

- Certain trade-offs arise in choosing how to design subsidies and mandates. To achieve near-universal coverage through subsidies alone would require that they cover a very large share of the premiums—which is an expensive proposition. But policymakers may also be reluctant to establish the penalties and enforcement mechanisms necessary to make a mandate effective. Other policies that adopted more limited versions of those three features could reduce the number of uninsured people to a lesser extent at a lower budgetary cost.

Second, with respect to controlling costs and improving efficiency—so that we get the best health for the amount we spend as a nation—some key considerations are these:

- Spending on health care has generally grown much faster than the economy as a whole, and that trend has continued for decades. In part, that growth reflects the improving capabilities of medical care—which can confer tremendous benefits by extending and improving lives. Studies attribute the bulk of cost growth to the development of new treatments and other medical technologies, but features of the health care and health insurance systems can influence how rapidly and widely new treatments are adopted.

- The high and rising costs of health care impose an increasing burden on the federal government as well as state governments and the private sector. Under current policies, CBO projects, federal spending on Medicare and Medicaid will increase from about 5 percent of gross domestic product (GDP) in 2009 to more than 6 percent in 2019 and about 12 percent by 2050. Most of that increase will result from growth in per capita costs rather than from the aging of the population. In the private sector, the growth of health care costs has contributed to slow growth in wages because workers must give up other forms of compensation to offset the rising costs of employment-based insurance.

- The available evidence also suggests that a substantial share of spending on health care contributes little if anything to the overall health of the nation, but finding ways to reduce such spending without also affecting services that improve health will be difficult. In many cases, the current system does not create incentives for doctors, hospitals, and other providers of health care—or their patients—to control costs. Significantly reducing the level or slowing the growth of health care spending below current projections would require substantial changes in incentives. Given the central role of medical technology in cost growth, reducing or slowing spending over the long term would probably require decreasing the pace of adopting new treatments and procedures or limiting the breadth of their application.

Third, controlling costs and improving efficiency present many challenges, but there are a number of approaches about which many analysts would probably concur:

- Many analysts would agree that payment systems should move away from a fee-for-service design and should instead provide stronger incentives to control costs, reward value, or both. A number of alternative approaches could be considered—including fixed payments per patient, bonuses based on performance, or penalties for substandard care—but their precise effects are uncertain. Policymakers may thus want to test various options (for example, using demonstration programs in Medicare) to see whether they work as intended or to determine which design features work best. Almost inevitably, though, reducing the amount that is spent on health care will involve some cutbacks or constraints on the number and types of services provided relative to currently projected levels.

- Many analysts would agree that the current tax exclusion for employment-based health insurance—which exempts most payments for such insurance from both income and payroll taxes—dampens incentives for cost control because it is open-ended. Those incentives could be changed by replacing the tax exclusion or restructuring it in ways that would encourage workers to join health plans with higher cost-sharing requirements and tighter management of benefits. (Given stronger incentives, the competition among health plans for enrollees could then determine the optimal mix of payment systems for providers.)

- Many analysts would agree that more information is needed about which treatments work best for which patients and about what quality of care different doctors, hospitals, and other providers deliver. The broad benefits that such information provides suggest a role for the government in funding research on the comparative effectiveness of treatments, in generating measures of quality, and in disseminating the results to doctors and patients. But absent stronger incentives to control costs and improve efficiency, the effect of information alone on spending will generally be limited.

- Many analysts would agree that controlling federal costs over the long term will be very difficult without addressing the underlying forces that are also causing private costs for health care to rise. Private insurers generally have more flexibility than Medicare's administrators to adapt to changing circumstances—a situation that policymakers may want to remedy—but changes made in the Medicare program can also stimulate broader improvements in the health sector.

Fourth, many of the steps that analysts would recommend might not yield substantial budgetary savings or reductions in national spending on health care within a 10-year window—and others might increase federal costs or total spending—for several reasons:

- In some cases, savings may materialize slowly because an initiative is phased in. For example, Medicare could save money by reducing payments to hospitals that have a high rate of avoidable readmissions (for complications following a discharge) but would have to gather information about readmission rates and notify hospitals before such reductions could be implemented. More generally, the process of converting innovative ideas into successful programmatic changes could take several years. Of course, for proposals that would increase the budget deficit, phase-in schedules reduce the amount of the increase that is captured in a 10-year budget window.

- Even if they generate some offsetting savings, initiatives are not costless to implement. For example, expanding the use of disease management services can improve health and may well be cost-effective—that is, the value of the benefits could exceed the costs. But those efforts may still fail to generate net reductions in spending on health care because the number of people receiving the services is generally much larger than the number who would avoid expensive treatments as a result. In other cases, most of the initial costs would be incurred in the first 10 years, but little of the savings would accrue in that period.

- Moreover, the effect on the federal budget of a policy proposal to encourage certain activities often differs from the impact of those activities on total spending for health care. For example, a preventive service could be cost-reducing overall, but if the government began providing that service for free, federal costs would probably increase—largely because many of the payments would cover costs for care that would have been received anyway.

- In some cases, additional steps beyond a proposal are needed for the federal government to capture savings generated by an initiative. For example, requiring that hospitals adopt electronic health records would reduce their costs for treating Medicare patients, but the program's payment rates would have to be reduced in order for the federal government to capture much of those savings.

- Savings from some initiatives may not materialize because incentives to reduce costs are lacking. For example, proposals to establish a "medical home" might have little impact on spending if the primary care physicians who would coordinate care were not given financial incentives to economize on their patients' use of services. Those proposals could increase costs if they simply raised payments to those primary care physicians.

- In some cases, estimating the budgetary effects of a proposal is hampered by limited evidence. Studies generally examine the effects of discrete policy changes but typically do not address what would happen if several changes were made at the same time. Those interaction effects could mean that the savings from combining two or more initiatives will be greater than or less than the sum of their individual effects.

Finally, I offer some observations on the issues that arise when trying to expand coverage and reduce costs at the same time:

- By themselves, steps to substantially expand coverage would probably increase total spending on health care and would generally raise federal costs. Those federal costs would be determined primarily by the number of people receiving subsidies of their premiums and the average amount of the subsidy. Steps that reduced the costs of the health insurance policies would limit the federal costs of providing premium subsidies but could not eliminate those costs.

- An expansion of coverage could be financed in a number of ways. One option is to limit or eliminate the current tax exclusion for employment-based health insurance. The savings from taking such steps would grow steadily because the revenue losses that stem from that exclusion are rising at the same rate as health care costs. The same can generally be said about using reductions in Medicare or Medicaid spending to offset the costs of expanding insurance coverage. Those methods of financing could adversely affect some people's current coverage, however, and other financing options that would either raise revenues or reduce other spending are also available.

On a broad level, many analysts agree about the direction in which policies would have to go in order to make the health care system more cost-effective: Patients and providers both need stronger incentives to control costs as well as more information about the quality and value of the care that is provided. But much less of a consensus exists about crucial details regarding how those changes are made—and similar disagreements arise about how to expand insurance coverage. In part, those disagreements reflect different values or different assessments of the existing evidence, but often they reflect a lack of evidence about the likely impact of making significant changes to the complex system of health insurance and health care.

CBO's Recent Volumes on Health Care

Concerns about the number of people who are uninsured and about the rising costs of health insurance and health care have given rise to proposals that would substantially modify the U.S. health insurance system and that seek to reduce federal or total spending for health care. The complexities of the health insurance and health care systems pose a major challenge for the design of such proposals and inevitably raise

questions about their likely impact. To assist the Congress in its upcoming deliberations, CBO has produced two major reports that address such proposals.

The December 2008 report titled *Key Issues in Analyzing Major Health Insurance Proposals* describes the assumptions that CBO would use in estimating the effects of various elements of such proposals on federal costs, insurance coverage, and other outcomes. It also reviews the evidence upon which those assumptions are based and, if the evidence points to a range of possible effects rather than a precise prediction, the factors that would influence where a proposal falls within the range. The report does not provide a comprehensive analysis of any specific proposal; rather, it identifies and examines many of the critical factors that would affect estimates of a variety of proposals. In particular, it considers the types of issues that would arise in estimating the effects of proposals to:

- Provide tax credits or other types of subsidies to make insurance less expensive to the purchaser;
- Require individuals to purchase health insurance, typically paired with a new system of government subsidies;
- Require firms to offer health insurance to their workers or pay into a fund that subsidizes insurance purchases;
- Replace employment-based coverage with new purchasing arrangements or provide strong incentives for people to shift toward individually purchased coverage; or
- Provide individuals with coverage under, or access to, existing insurance plans such as the Medicare program, either as an additional option or under a "Medicare-for-all" single-payer arrangement.

Wherever possible, the analysis describes in quantitative terms how CBO would estimate the budgetary and other effects of such proposals. In other cases, it describes the components that a proposal would have to specify in order to permit estimation of those effects. The report reflects the current state of CBO's analysis of and judgments about the likely response of individuals, employers, insurers, and providers to changes in the health insurance and health care systems. Certainly, the details of particular policies and the way in which they are combined, as well as new evidence or analysis related to the issues discussed here, could affect CBO's estimates of the effects of large-scale health insurance proposals.

The December 2008 report titled *Budget Options, Volume 1: Health Care,* comprises 115 discrete options to alter federal programs, affect the private health insurance market, or both. It includes many options that would reduce the federal budget deficit and some that would increase it. Although similar to CBO's previous reports on budget options, this volume reflects an extensive and concerted effort to substantially

expand the range of topics and types of proposals considered and includes estimates of many approaches that the agency had not previously analyzed. (Volume 2, containing budget options that are not related to health care, is forthcoming.) The report is organized thematically, rather than by program, and covers the following areas:

- The private health insurance market and the tax treatment of health insurance;
- Changing the availability of health insurance through existing federal programs;
- The quality and efficiency of health care and geographic variation in spending for Medicare;
- Paying for services in Medicare, Medicaid, and the Children's Health Insurance Program (CHIP);
- Premiums and cost sharing in federal health programs;
- Long-term care;
- Health behavior and health promotion; and
- Closing the gap between Medicare's spending and receipts.

The options that were included stem from a variety of sources, including extensive discussions with Congressional staff; reviews of legislative proposals, the President's budget, and academic literature; and analyses conducted by CBO staff, other government agencies, and private groups. Although the number of health-related policy options is significantly greater than in previous *Budget Options* volumes, it is not an exhaustive list. CBO's estimates are sensitive to the precise specifications of each option and could change in the future for a variety of reasons, including changes in economic conditions or other factors that affect projections of baseline spending or the availability of new evidence about an option's likely effects. It should also be noted that the options' effects may not be additive; that is, there could be important interaction effects among options that make their cumulative impact larger or smaller than the sum of the estimates. Some of the options that are particularly complex may be candidates for demonstration projects or pilot programs, which could help resolve the uncertainty about their effects.[1]

The remainder of my testimony largely summarizes the conclusions reached in the *Key Issues* volume. Those conclusions—and the background information and evidence

1. Estimates of the impact on revenues of proposals to change the federal tax code are prepared by the staff of the Joint Committee on Taxation (JCT) and would be incorporated into any formal CBO estimate of a proposal's effects on the federal budget. For its recent reports on health care, CBO consulted with JCT about the behavioral considerations that are incorporated into both agencies' estimates, and JCT prepared the revenue estimates for several of the options.

on which they are based—are also relevant to much of CBO's analysis for the *Budget Options* volume. Although summarizing all 115 options would not be feasible here, my testimony highlights some of the agency's main findings.

Background on Spending and Coverage

Spending on health care and related activities will account for about 18 percent of GDP in 2009—an expected total of $2.6 trillion—and under current law that share is projected to reach 20 percent by 2017. Annual health expenditures per capita are projected to rise from about $8,300 to about $13,000 over that period. Federal spending accounts for about one-third of those totals, and federal outlays for the Medicare and Medicaid programs are projected to grow from about $720 billion in 2009 to about $1.4 trillion in 2019. Over the longer term, rising costs for health care represent the single greatest challenge to balancing the federal budget. (For additional discussion, see the November 2007 CBO report *The Long-Term Outlook for Health Care Spending*.)

The number of people who are uninsured is also expected to increase because health insurance premiums are likely to continue rising much faster than income, which will make insurance more difficult to afford. As noted above, CBO estimates that the average number of nonelderly people who are uninsured will rise from at least 45 million in 2009 to about 54 million in 2019. The estimate for 2009 does not reflect the recent deterioration in economic conditions, which could result in a larger uninsured population, nor does it take into account recently enacted legislation.

Employment-Based Insurance

For several reasons, most nonelderly individuals obtain their insurance through an employer, and employment-based plans now cover about 160 million people, including spouses and dependents. One fundamental reason such plans are popular is that they are subsidized through the tax code—because nearly all payments for employment-based insurance are excluded from taxable compensation and thus are not subject to income and payroll taxes. Another factor is the economies of scale that larger group purchasers enjoy, which reduce the average amount of administrative costs that are embedded in premiums; partly as a result, large employers are more likely than small employers to offer insurance to their workers. Overall, about three-fourths of workers are offered employment-based insurance and are eligible to enroll in it.

Another commonly cited reason for the popularity of employment-based policies is that employers offering coverage usually pay most of the premium—a step they take partly to encourage broad enrollment in those plans, which helps keep average costs stable. Ultimately, however, the costs of those employers' payments are passed on to employees as a group, mainly in the form of lower wages.

Other Sources of Coverage

Other significant sources of coverage for nonelderly people include the individual insurance market and various public programs. Roughly 10 million people are covered by individually purchased plans, which have some advantages for enrollees; for example, they may be portable from job to job, unlike employment-based insurance. Even so, individually purchased policies generally do not receive favorable tax treatment. In most states, premiums may vary to reflect an applicant's age or health status, and applicants with particularly high expected costs are generally denied coverage.

Another major source of coverage is the federal/state Medicaid program and the related but smaller CHIP. Both programs provide free or low-priced coverage for children in low-income families and (to a more limited degree) their parents; Medicaid also covers poor individuals who are blind or disabled. On average, Medicaid and CHIP are expected to cover about 43 million nonelderly people in 2009 (and there are also many people eligible for those programs who have not enrolled in them).[2] Medicare also covers about 7 million people younger than 65 who are disabled or have severe kidney disease.

About 12 million people have insurance coverage from various other sources, including federal health programs for military personnel. The total number of nonelderly people with health insurance at any given point in 2009 is expected to be about 216 million.

Approaches for Reducing the Number of Uninsured People

Concerns about the large number of people who lack health insurance have generated proposals that seek to increase coverage rates substantially or achieve universal or near-universal coverage. Two basic approaches could be used:

- Subsidizing health insurance premiums, either through the tax system or spending programs, which would make insurance less expensive for people who are eligible, or

- Establishing a mandate for health insurance, either by requiring individuals to obtain coverage or by requiring employers to offer health insurance to their workers.

By themselves, premium subsidies or mandates to obtain health insurance would not achieve universal coverage. Those approaches could be combined and could be implemented along with provisions to facilitate enrollment in ways that could achieve near-universal coverage. (Many of the issues and trade-offs that arise in designing such

2. That figure represents average enrollment (rather than the number of people enrolled at any time during the year) and excludes nonelderly individuals living in institutions (such as nursing homes), people living in U.S. territories, and people receiving only limited benefits under Medicaid (such as family planning services).

initiatives are also illustrated by the more incremental options to expand insurance coverage that are examined in the *Budget Options* volume.)

Subsidizing Premiums

Whether new subsidies are delivered through the tax system or a spending program, several common issues arise. Trade-offs exist between the share of the premiums that is subsidized, the number of people who enroll in insurance as a result of the subsidies, and the total costs of the subsidies. As the subsidy rate increases, more people will be inclined to take advantage of them, but the higher subsidy payments will also benefit those who would have decided to obtain insurance anyway. Beyond a certain point, therefore, the cost per newly insured person can grow sharply because a large share of the additional subsidy payments is going to otherwise insured individuals.

To hold down the costs of subsidies, the government could limit eligibility for subsidy payments to individuals who are currently uninsured. That restriction, however, would create incentives for insured individuals to drop their coverage. Some proposals might try to distinguish between people who become uninsured in response to subsidies and those who would have been uninsured in the absence of a government program (for example, by imposing waiting periods for individuals who were previously enrolled in an employment-based plan), but such proposals could be very difficult to administer. In addition, providing benefits only to the uninsured might be viewed as unfair by people with similar income and family responsibilities who purchased health insurance and would therefore be ineligible for the subsidies.

Another approach to limiting costs would target subsidies toward the lower-income groups, who are most likely to be uninsured otherwise, but such approaches can also have unintended consequences that affect the costs of a proposal. If eligibility was limited to people with income below a certain level, then those with income just above the threshold would have strong incentives to work less or hide income in order to qualify for the subsidies or maintain their eligibility. Phasing out subsidies gradually as income rises would reduce those incentives, but it would increase the amount of subsidy payments that go to individuals and families who would have had insurance in any event.

Restructuring the Existing Tax Subsidies. Tax subsidies could be restructured to expand coverage in several ways. For example, the current tax exclusion for employment-based health insurance could be replaced with a deduction or tax credit to offset the costs of insurance, and tax subsidies could be extended to include policies purchased in the individual insurance market. That step would sever the link between employment and tax subsidies for private health insurance and could give similar people the same subsidy whether or not they were offered an employment-based health plan.

Deductions and credits differ, however, in their effectiveness at reaching the uninsured. An income tax deduction might provide limited benefits to low-income

individuals because, like the existing exclusion, its value is less for those in lower tax brackets. In contrast, tax credits can be designed to provide lower- and moderate-income taxpayers with larger benefits than they would receive from tax deductions or exclusions. An important question regarding tax credits—particularly for lower-income people who pay relatively little in income taxes and are also more likely to be uninsured—is whether the credits would be refundable and therefore fully available to individuals with little or no income tax liability.

For the same budgetary costs, a refundable tax credit might be more effective at increasing insurance coverage, both because it can be designed to provide a larger benefit to low-income people than they receive under current law and because those recipients might be more responsive to a given subsidy than are people with higher income. Still, the effect on coverage rates might be limited if people do not receive refundable tax credits before their premium payments are due.

Providing Subsidies Through Spending Programs. The government could seek to increase coverage rates by spending funds to subsidize insurance premiums. New subsidies could be provided implicitly by expanding eligibility for Medicare, Medicaid, or CHIP or explicitly by creating a new program. To hold costs down, benefits could be targeted on the basis of income, assets, family responsibilities, and insurance status. Targeting benefits, however, would require program administrators to certify eligibility and enforce the program's rules, which would affect coverage and the program's costs.

The Effects of Subsidy Proposals. Proposals to subsidize insurance coverage would affect decisions by both employers and individuals. Employers' decisions to offer insurance to their workers reflect the preferences of their workers, the cost of the insurance that they can provide, and the costs of alternative sources of coverage that workers would have. Smaller firms appear to be more sensitive to changes in the cost of insurance than are larger employers. Subsidies that reduce the cost of insurance offered outside the workplace would cause some firms to drop coverage or reduce their contributions. When deciding whether to enroll in employment-based plans, workers would consider the share of the premium that they pay as well as the price and attractiveness of alternatives. The available evidence indicates that a small share of the population would be reluctant to purchase insurance even if subsidies covered nearly all of the costs.

Related Budget Options. Several of the alternatives included in CBO's *Budget Options* volume highlight the potential effects of changing the tax treatment of health insurance. For example, Option 10 would replace the current exclusion from income taxes for employment-based health insurance with a tax deduction that phases out at higher income levels. That option would increase federal revenues by approximately $550 billion through 2018 (as estimated by the staff of the Joint Committee on Taxation). Because that option would increase the effective price of health insurance for higher-income taxpayers, it would, by CBO's estimation, increase the number of

uninsured people by about 1.5 million in 2014 (in part because some employers would decide to stop offering coverage). Those estimates are sensitive to the parameters of the deduction and particularly to the range of income over which the deduction is phased out.

Other examples illustrate the effects on federal costs and coverage that stem from targeting different populations. Allowing low-income young adults to enroll in Medicaid, as described in Option 23, would cover about 1.1 million people in 2014, at a federal cost of about $22 billion over the 2010–2019 period, according to CBO's estimates. Allowing low-income parents with children eligible for Medicaid to enroll in the program, as described in Option 24, would cost about $38 billion over the same period and would expand coverage to about 1.4 million parents and 700,000 children in 2014.

Another approach is illustrated by Option 7, which would create a voucher program to subsidize the purchase of health insurance for households with income below 250 percent of the federal poverty level. Specifically, individuals would receive up to $1,500, and families would receive up to $3,000. According to CBO's estimates, that approach would reduce the net number of uninsured people by about 2.2 million in 2014. Overall, approximately 4 million people would use the voucher, but about 1.7 million of those people would have had coverage in the individual health insurance market or through an employer. In addition, about 100,000 people would become newly uninsured as a result of small employers' electing not to offer coverage because of the new voucher program. The total cost to the federal government of such a voucher program would be about $65 billion over the next decade.

Mandating Coverage

In an effort to increase the number of people who have health insurance or to achieve universal or near-universal coverage, the government could require individuals to obtain health insurance or employers to offer insurance plans. Employer mandates could include a requirement that employers contribute a certain percentage of the premium, which would encourage their workers to purchase coverage. To the extent that the required contributions exceeded the amounts that employers would have paid under current law, offsetting reductions would ultimately be made in wages and other forms of compensation.

The impact of a mandate on the number of people covered by insurance would depend on its scope, the extent of enforcement, and the incentives to comply, as well as the benefits that enrollees received. Individual mandates, for example, could be applied broadly to the entire population of the United States or to a specific group, such as children; employer mandates might vary by the size of the firm. (Option 3 in the *Budget Options* volume is a specific requirement for large employers to offer coverage or pay a fee. Under the provisions of that option, the number of newly insured individuals would be relatively small, only about 300,000.)

Penalties would generally increase individuals' incentives to comply with mandates, but when deciding whether to obtain insurance, people would also consider the likelihood of being caught if they did not comply. Data from the tax system and from other government programs, where overall rates of compliance range from roughly 60 percent to 90 percent, indicate that mandates alone would not achieve universal coverage, largely because some people would still be unwilling or unable to purchase insurance.

Facilitating Enrollment

Simplifying the process of enrolling in health insurance plans or applying for subsidies could yield higher coverage rates and could also increase compliance with a mandate to obtain coverage. One approach would be to enroll eligible individuals in health insurance plans automatically, giving them the option to refuse that coverage or to switch to a different plan. Automatic enrollment has been found to increase participation rates in retirement plans and government benefit programs. It requires the government, an employer, or some other entity to determine the specific plan into which people will be enrolled, however, and those choices may not always be appropriate for everyone.

Factors Affecting Insurance Premiums

Premiums for employment-based plans are expected to average about $5,000 per year for single coverage and about $13,000 per year for family coverage in 2009. Premiums for policies purchased in the individual insurance market are, on average, much lower—about one-third lower for single coverage and one-half lower for family policies. Those differences largely reflect the fact that policies purchased in the individual market generally cover a smaller share of enrollees' health care costs, which also encourages enrollees to use fewer services. An offsetting factor is that average administrative costs are much higher for individually purchased policies. The remainder of the difference in premiums probably arises because people who purchase individual coverage have lower expected costs for health care to begin with.

The federal costs of providing premium subsidies, and the effects of those subsidies on the number of people who are insured, would depend heavily on the premiums charged. Premiums reflect the average cost that any insurer—public or private—incurs, and those costs are a function of several factors:

- The scope of benefits the coverage includes and its cost-sharing requirements,
- The degree of benefit management that is conducted,
- The administrative costs the insurer incurs, and
- The health status of the individuals who enroll.

Insurers' costs also depend on the mechanisms and rates used to pay providers and on other forces affecting the supply of health care services. Proposals could affect many of those factors directly or indirectly. For example, the government might specify a minimum level of benefits that the coverage must provide in order to qualify for a subsidy or fulfill a mandate; such a requirement could have substantial effects on the proposal's costs or its impact on coverage rates.

Design of Benefits, Cost Sharing, and Related Budget Options

Health insurance plans purchased in the private market tend to vary only modestly in the scope of their benefits—with virtually all plans covering hospital care, physicians' services, and prescription drugs—but they vary more substantially in their cost-sharing requirements. A useful summary statistic for comparing plans with different designs is their "actuarial value," which essentially measures the share of health care spending for a given population that each plan would cover. Actuarial values for employment-based plans typically range between 65 percent and 95 percent, with an average value between 80 percent and 85 percent. Cost-sharing requirements for enrollees tend to be greater for policies purchased in the individual insurance market, where actuarial values generally range from 40 percent to 80 percent, with an average value between 55 percent and 60 percent.

Public programs also vary in the extent of the coverage they provide. Medicaid requires only limited cost sharing (reflecting the low income of its enrollees); cost sharing under CHIP may be higher but is capped as a share of family income. Medicare's cost sharing varies substantially by the type of service provided; for example, home health care is free to enrollees, but most hospital admissions incur a deductible of about $1,000. In addition, the program does not cap the out-of-pocket costs that enrollees can incur. Overall, the actuarial value of Medicare's benefits for the nonelderly population is about 15 percent lower than that of a typical employment-based plan. Those considerations would affect CBO's analysis of proposals to expand enrollment in public programs.

In general, the more comprehensive the coverage provided by a health plan, the higher the premium or cost per enrollee. Indeed, an increase in a health plan's actuarial value would also lead enrollees to use more health care services. Reflecting the available evidence, CBO estimates that a 10 percent decrease in the out-of-pocket costs that enrollees have to pay would generally cause their use of health care to increase by about 1 percent to 2 percent. The agency would apply a similar analysis to proposals that included subsidies to reduce the cost-sharing requirements that lower-income enrollees face.

Several budget options examine the effects of changing cost-sharing requirements in the Medicare program. Option 81 would replace the program's current requirements with a unified deductible, a uniform coinsurance rate, and a limit on out-of-pocket costs. That option would reduce federal spending by about $26 billion over 10 years —mostly because of the increase in cost sharing for some services and the resulting

reduction in their use. Option 83 would combine those changes in the Medicare program with limits on the extent to which enrollees could purchase supplemental insurance policies (known as medigap plans) that typically cover all of Medicare's cost-sharing requirements. That option would reduce federal spending by about $73 billion over 10 years—with the added savings emerging because enrollees would be more prudent in their use of care once their medigap plans did not cover all of their cost-sharing requirements. Options 84, 85, and 86 would reduce federal outlays by imposing cost sharing for certain Medicare services that are now free to enrollees, and Option 89 would increase federal outlays by eliminating the gap in coverage (commonly called the doughnut hole) in the design of Medicare's drug benefit. Options 95 through 98 would reduce federal spending by introducing or increasing cost-sharing requirements for health care benefits provided to veterans, military retirees and their dependents, and dependents of active-duty personnel.

Management of Benefits

Another factor affecting health insurance premiums and thus the costs or effects of legislative proposals is the degree of benefit and cost management that insurers apply. Nearly all Americans with private health insurance are enrolled in some type of "managed care" plan, but the extent to which specific management techniques are used varies widely. Common techniques to constrain costs include negotiating lower fees with a network of providers, requiring that certain services be authorized in advance, monitoring the care of hospitalized patients, and varying cost-sharing requirements to encourage the use of less expensive prescription drugs. Overall, CBO estimates, premiums for plans that made extensive use of such management techniques would be 5 percent to 10 percent lower than for plans using minimal management. Conversely, proposals that restricted plans' use of those tools would result in higher health care spending than proposals that did not impose such restrictions.

Administrative Costs

Some proposals would affect the price of health insurance by changing insurers' administrative costs. Some types of administrative costs (such as those for customer service and claims processing) vary in proportion to the number of enrollees in a health plan, but others (such as those for sales and marketing efforts) are more fixed; that is, those costs are similar whether a policy covers 100 enrollees or 100,000. As a result of those economies of scale, the average share of the policy premium that covers administrative costs varies considerably—from about 7 percent for employment-based plans with 1,000 or more enrollees to nearly 30 percent for policies purchased by very small firms (those with fewer than 25 employees) and by individuals.

Some administrative costs would be incurred under any system of health insurance, but proposals that shifted enrollment away from the small-group and individual markets could avoid at least a portion of the added administrative costs per enrollee that are observed in those markets. In general, however, substantial reductions in administrative costs would probably require the role of insurance agents and brokers

in marketing and selling policies to be sharply curtailed and the services they provide to be rendered unnecessary.

Spending by Previously Uninsured People

The impact that the mix of enrollees has on health insurance premiums is also an important consideration, particularly for proposals that would reduce the number of people who are uninsured. The reason is that the use of health care by the previously uninsured will generally increase when they gain coverage. On average, the uninsured currently use about 60 percent as much care as the insured population, CBO estimates, after adjusting for differences in demographic characteristics and health status between the two groups.

On the basis of the research literature and an analysis of survey data, CBO estimates that enrolling all people who are currently uninsured in a typical employment-based plan would increase their use of services by 25 percent to 60 percent; that is, they would use between 75 percent and 95 percent as many services as a similar group of insured people. The remaining gap in the use of services reflects the expectation that, on average, people who are uninsured have a lower propensity to use health care, a tendency that would persist even after they gained coverage. For more incremental increases in coverage rates, CBO would expect that people who chose to enroll in a new program would be more likely to use medical care than those who decided not to enroll.

In addition, recent estimates indicate that about a third of the care that the uninsured receive is either uncompensated or undercompensated—that is, they either pay nothing for it or pay less than the amount that a provider would receive for treating an insured patient. To the extent that such care became compensated under a proposal to expand coverage, health care spending for the uninsured would increase, regardless of whether their use of care also rose.

Proposals Affecting the Choice of an Insurance Plan

The government could affect the options available to individuals when choosing a health insurance plan—and the incentives they face when making that choice—in a number of ways. In particular, proposals could establish or alter regulations governing insurance markets, seek to reveal more fully the relative costs of different health insurance plans, or have the federal government offer new health insurance options.

The effects of proposals on insurance markets would depend on more than the impact they have on the premiums charged or on the share of the premium that enrollees have to pay; those effects would also reflect the market dynamics that arise as individuals shift among coverage options and as policy premiums adjust to those shifts. In particular, the risk that some plans would experience "adverse selection"—that is, that their enrollees will have above-average or higher-than-expected costs for health care—

has important implications for the operation of insurance markets and for proposals that would regulate those markets or introduce new insurance options.

Insurance Market Regulations and Related Budget Options

Proposals could seek to establish or alter regulations governing the range of premiums that insurers may charge or the terms under which individuals and groups purchase coverage. Purchases in the individual insurance market and most policies for small employers are governed primarily by state regulations. Those regulations differ in the extent to which they limit variation in premiums, require insurers to offer coverage to applicants, permit exclusions for preexisting health conditions, or mandate coverage of certain benefits. Roughly 20 percent of applicants for coverage in the individual market have health problems that raise their expected costs for health care substantially, and in most states they may be charged a higher premium or have their application denied; as a result, premiums are correspondingly lower in those states for the majority of applicants.

Proposals might seek to modify the regulation of health insurance markets in order to make insurance more affordable for people with health problems or to give consumers more choices, but those goals might conflict with each other. For example, limiting the extent to which premiums for people in poor health can exceed those for people in better health (as some states currently do) would reduce premiums for those who have higher expected costs for health care, but it would also raise premiums for healthier individuals and thus could reduce their coverage rates. Other proposals might counteract such limits on variations in premiums—for example, by allowing people to buy insurance in other states. That approach would enable younger and relatively healthy individuals living in states with tight limits to purchase a cheaper policy in another state. Older and less healthy residents who continued to purchase individual coverage in the tightly regulated states, however, would probably face higher premiums as a result.

By themselves, changes in the regulation of the small-group and individual insurance markets would generally have modest effects on the federal budget and on the total number of people who are insured. Those budgetary effects would primarily reflect modest shifts into or out of Medicaid, CHIP, or employment-based coverage as those options became more or less attractive relative to coverage in the individual market. Proposals to require insurers to cover all applicants or to guarantee coverage of preexisting health conditions would benefit people whose health care would not be covered otherwise, but insurers would generally raise premiums to reflect the added costs.

Another approach that has attracted attention recently involves so-called high-risk pools. Most states have established such pools to subsidize insurance for people who have high expected medical costs and have either been denied coverage in the individual insurance market or been quoted a very high premium. Overall participation in high-risk pools is limited—there are currently about 200,000 enrollees nationwide—but proposals could seek to expand the use of those pools by providing new federal

subsidies. The costs of such subsidies would depend primarily on the average health care costs of enrollees, the share of those costs covered by the pool, and the number of people who enrolled as a result.

CBO analyzed several specific options related to the regulation of insurance markets in its *Budget Options* volume. For example, Option 2 would allow insurers licensed in one state to sell policies to individuals living in any other state and to be exempt from the regulations of those other states. Under that option, premiums would tend to rise for people with higher expected costs for health care living in states that tightly regulate insurance markets, and premiums would fall correspondingly for low-cost individuals in those states because some of them would find insurance policies with lower premiums sold in other states with looser regulations. As a result, according to CBO's estimates, by 2014 about 600,000 people with relatively low expected health care spending would gain coverage and about 100,000 people with higher expected costs would drop their coverage. In addition, some firms would stop offering health insurance plans altogether, resulting in an additional loss of coverage for about 100,000 employees and their dependents. Those changes in coverage would generate nearly $8 billion in additional federal revenues over 10 years, as some compensation shifted from untaxed health benefits to taxable wages. Among those who were no longer offered employment-based coverage, a small number would enroll in Medicaid causing roughly a $400 million increase in federal outlays over the 2010–2019 period.

Option 6 would require states to use "community rating" of premiums for small employers who purchase coverage from an insurer—meaning that insurers would have to charge all applicants the same per-enrollee premium for a given policy. Under that option, total enrollment in the small-group health insurance market would fall by about 400,000 (or roughly 1 percent of current enrollment) in 2014, reflecting the net effect of both increased enrollment by people with high expected costs and decreased enrollment by people with low expected costs. The budget deficit would be reduced by about $5 billion over the next decade, largely as a result of higher tax revenues. Option 4 would require all states to establish high-risk pools and provide federal subsidies toward enrollees' premiums. Enrollees would be responsible for paying premiums up to 150 percent of the standard rate for people of similar age. That option would increase the deficit by about $16 billion over the 2010–2019 period; on net, about 175,000 individuals who would have been uninsured otherwise would gain insurance coverage in 2014.

Steps to Reveal Relative Costs

Some proposals would seek to restructure the choices that individuals face—and expose more clearly the relative costs of their health insurance options—either by reducing or eliminating the current tax subsidy for employment-based insurance or by encouraging or requiring the establishment of managed competition systems. Both approaches would provide stronger incentives for enrollees to weigh the expected benefits and costs of policies when making decisions about purchasing insurance. As a

result, many enrollees would choose health insurance policies that were less extensive, more tightly managed, or both, compared with the choices made under current law.

The current tax exclusion for the premiums of employment-based health plans provides a subsidy of about 30 percent, on average, if both the income and payroll taxes that are avoided are taken into account. Eliminating that exclusion, or replacing it with a fixed-dollar tax credit or deduction, would effectively require employees to pay a larger share of the added costs of joining a more expensive plan; conversely, employees would capture more of the savings from choosing a cheaper plan. As a result, according to CBO's estimates, people would ultimately select plans with premiums that were between 15 percent and 20 percent lower than the premiums they would pay under current law. Less extensive changes, such as capping the amount that may be excluded at a certain dollar value, would have proportionally smaller effects on average premiums.

The key features of a managed competition system involve a sponsor, such as an employer or government agency, offering a structured choice of health plans and making a fixed-dollar contribution toward the cost of that insurance. Enrollees would thus bear the cost of any difference in premiums across plans. In CBO's estimation, a proposal requiring that approach would yield average premiums for health insurance that were about 5 percent lower than those chosen under current law. Proposals that also adopted other features of managed competition, such as standardization of benefits across plans and adjustments of sponsors' payments to those plans to reflect the health risk of each enrollee, might yield more intense competition among plans and help avoid problems of adverse selection.

Federally Administered Options and Related Budget Options

Under some proposals, the federal government would make available additional options for insurance—for example, by providing access to the private health plans that are offered through the Federal Employees Health Benefits (FEHB) program. The effects of that approach would depend critically on how the premiums for nonfederal enrollees were set. If insurers could charge different premiums to different applicants on the basis of their expected costs for health care, the option would resemble the current small-group and individual markets and thus would have little impact. Alternatively, if new enrollees were all charged the same premium, the FEHB plans would be most attractive to people who expected to have above-average costs for health care. If no subsidies were provided, the total premiums charged to nonfederal enrollees would probably be much higher than those observed in the program today—so the number of new enrollees would probably be limited. Depending on the specific features of such proposals, providing access to FEHB plans might not prove to be financially viable because of adverse selection into those plans.

The government could also design an insurance option based on Medicare that would be made more broadly available, on a voluntary basis, to the nonelderly population. The federal costs per enrollee would depend primarily on the benefits that system pro-

vided; the rates used to pay doctors, hospitals, and other providers of health care; and the extent of any premium subsidies that were offered to enrollees—all of which could differ from Medicare's current design. As for whether such a plan would be more or less costly than a private health insurance plan that provided the same benefits to a representative group of enrollees, the answer would vary geographically. Assuming that Medicare's current rules applied, those costs would be comparable in many urban areas, but in other areas, the cost of the government-run plan would be lower (as is evident in the current program through which Medicare beneficiaries may enroll in a private health plan). At the same time, because Medicare currently provides broad access to doctors and hospitals and employs little benefit management, a Medicare-based option might attract relatively unhealthy enrollees, which could drive up its premiums, federal costs, or both.

Many of the same considerations would arise in designing a single-payer, Medicare-for-all system, but that approach might raise some unique issues as well—and the scale of its impact on federal costs could obviously be much larger if nearly all of the population was covered. Enrollees could be offered a choice of plans under a single-payer system (as happens in Medicare). If, instead, only one design option was offered and all residents were required to enroll in it, then concerns about adverse selection would not arise. That approach could also reduce the administrative costs that doctors and hospitals currently incur when dealing with multiple insurers. The lack of alternatives with which to compare that program, however, could make it more difficult to assess the system's performance. More generally, that approach would raise important questions about the role of the government in managing the delivery of health care.

Under the provisions of Option 27 in the *Budget Options* volume—which would allow individuals and employers to buy into the FEHB program—CBO estimates that about 2.3 million people would enroll in 2014, of whom about 1.3 million would have been uninsured otherwise. The new program would constitute a separate insurance risk pool for nonfederal enrollees, and their premiums would not be the same as those for federal employees. However, premiums would be the same for all nonfederal enrollees within each plan in a particular geographic area and would be structured so that they did not lead to any new outlays by the federal government. The estimate reflects an assessment that the individuals who enrolled in the program would have greater-than-average health risks, which would lead to higher premiums than if the entire eligible population had enrolled in the program. Although considerable uncertainty exists about the financial viability of FEHB plans in such a program, CBO estimated that features such as an annual open-enrollment period, limited exclusions of coverage for preexisting health conditions, and participation by small employers would limit adverse selection and yield a stable pool of enrollees. The buy-in option would increase the deficit by almost $3 billion from 2010 to 2019, reflecting the net effect of reduced revenues (from a shift in employers' compensation to nontaxable health insurance) and reduced outlays from lower enrollment in Medicaid.

Option 18 would establish a Medicare buy-in program for individuals ages 62 to 64. CBO's analysis reflects an assessment that the government could set a premium at a level such that the program was self-financing; that is, the premium would not be subsidized (and a mechanism would be established to ensure that outcome). As with the option to buy into the FEHB program, CBO would expect the buy-in program to attract individuals with higher-than-average health risks. Although the program would be structured so that enrollees paid its full costs through their premiums, federal spending would increase by about $1 billion over 10 years because some people would choose to retire—and thus receive Social Security benefits—earlier than they would have otherwise. In a typical year of the buy-in program, CBO estimates, about 300,000 people would participate, of whom 200,000 would otherwise have purchased individual coverage, 80,000 would have been uninsured, and 20,000 would have remained employed and had employment-based coverage.

Factors Affecting the Supply and Prices of Health Care Services

The ultimate effects of proposals on the use of and spending for health care depend not only on factors that affect the demand for health care services, such as the number of people who are insured and the scope of their coverage, but also on factors that affect the supply and prices of those services. The various methods used for setting prices and paying for services, and the resulting payment rates, affect the supply of health care services by influencing the decisions that doctors, hospitals, and other providers of care make about how many patients to serve and which treatments their patients will receive. Average payment rates for Medicare, Medicaid, and private insurers also differ, which would affect the budgetary impact of proposals that shifted enrollees—and their costs—from one source of coverage to another. Changes in payment rates for public programs or in the amount of uncompensated care provided to the uninsured could also affect private payment rates.

Payment Methods, Incentives for Providers, and Related Budget Options

Most care provided by physicians in the United States is paid for on a fee-for-service basis, meaning that a separate payment is made for each procedure, each office visit, and each ancillary service (such as a laboratory test). Hospitals are generally paid a fixed amount per admission (a bundled payment to cover all of the services that the hospital provides during a stay) or an amount per day. Such payments may encourage doctors and hospitals to limit their own costs when delivering a given service or bundle, but they can also create an incentive to provide more services or more expensive bundles if the additional payments exceed the added costs.

Other arrangements, such as salaries for doctors or periodic capitation payments (fixed amounts per patient), do not provide financial incentives to deliver additional services. Those approaches raise concerns, however, about providers' incentives to stint on care or avoid treating sicker patients. One study randomly assigned enrollees to different health plans and found that those in an integrated plan (which owns the hospitals used by enrollees and pays providers a salary) used 30 percent fewer services

than enrollees in a fee-for-service plan, but whether those results could be replicated more broadly is unclear.

Proposals could seek to change payment methods either indirectly or directly. They could change the payment methods used by private health plans indirectly by encouraging shifts in enrollment toward plans that have lower-cost payment systems. For public programs, such as Medicare and Medicaid, federal policymakers could directly change payment methods. In either case, making those changes could prove to be very difficult.

Chapter 5 of CBO's *Budget Options* volume examines a number of policies that could change the way that providers are paid and thus the incentives they have. Most of those options focus on Medicare, but other options address Medicaid or the larger health care system. Some options would involve relatively modest changes in payment methods, but others would make more dramatic changes to those methods and thus to incentives for providers. Given the significant uncertainty surrounding the effects of some approaches, a series of pilot projects or demonstration programs might provide valuable insights into how to design new payment systems to achieve lower spending while maintaining or improving the quality of care.

Option 30, for example, would bundle Medicare's payments for hospital and post-acute care. Under the specifications of that option, federal spending would be reduced by about $19 billion over the 2010–2019 period, CBO estimates. That approach would constitute a significant change in the way Medicare pays for post-acute care (which includes services provided by skilled nursing facilities and home health agencies). Medicare would no longer make separate payments for post-acute care services following an acute care inpatient hospital stay. Instead, the unit of payment for acute care provided in hospitals would be redefined and expanded to include post-acute care provided both there and in nonhospital settings. Hospitals would have incentives to reduce the cost of post-acute care for Medicare beneficiaries by lessening its volume and intensity or by contracting with lower-cost providers.

Option 38 illustrates how Medicare could move away from fee-for-service payments to physicians in favor of a blend of capitated and per-service payments. That option would require the Centers for Medicare and Medicaid Services (CMS) to assign each beneficiary who participates in fee-for-service Medicare to a primary care physician. Those physicians would receive approximately three-fourths of their Medicare payments on a per-service basis and approximately one-fourth under a capitated arrangement; they would also receive bonuses or face penalties, depending on the total spending for all Medicare services incurred by their panel of beneficiaries. In response to the incentives created by that payment approach, physicians would probably try to reduce spending among their panel of patients in several ways—for example, by limiting referrals to specialists, increasing their prescribing of generic medications, and reducing hospitalizations for discretionary procedures. According to CBO's estimates, this option would increase payments to physicians and decrease

payments to all other Medicare providers, with a net federal savings of about $5 billion between 2010 and 2019.

Payment Rates and Related Budget Options

The financial incentives created by different payment systems—and the spending amounts they yield—also depend on the level at which payment rates, or prices, are set. Those rates depend partly on the methods that are used to set them. Private-sector payment rates are set by negotiation, reflecting the underlying costs of the services and the relative bargaining power of providers and health plans; in turn, bargaining power depends on factors such as the number of competing providers or provider groups within a local market area. Fee-for-service payment rates in Medicare and Medicaid are generally set administratively. That method poses a number of challenges, including how to determine providers' costs—particularly for services that require substantial training or that become cheaper to provide when they are performed more frequently. Additional issues include how to account for the quality of those services and their value to patients, and what impact rate setting might have on the development of new medical technology.

On average, payment rates under Medicare and Medicaid are lower than private payment rates. Specifically, Medicare's payment rates for physicians in 2006 were nearly 20 percent lower than private rates, on average, and its average payment rates for hospitals were as much as 30 percent lower. As for Medicaid, recent studies indicate that its payment rates for physicians and hospitals were about 40 percent and 35 percent lower, respectively, than private rates. Within Medicare, and probably within Medicaid as well, those differentials vary geographically and tend to be larger in rural areas and smaller in urban areas (where competition among providers is generally greater). Given those differences, proposals that shifted enrollment between private and public plans could have a large impact on payments to providers and on spending for health care. Depending on how providers responded to those changes, enrollees' access to care could be affected.

Chapters 7 and 8 of the *Budget Options* volume examine a wide variety of ways in which payment rates for medical services and supplies could be changed under both the Medicare and Medicaid programs. In particular, Option 55 would reduce (by 1 percentage point) the annual update factor under Medicare for inpatient hospital services; by CBO's estimates, that change would yield $93 billion in savings over 10 years. Option 59 includes several alternatives for increasing payment rates for physicians under Medicare, which (under current law) are scheduled to fall by about 21 percent in 2010 and by about 5 percent annually for several years thereafter. The 10-year cost of those alternatives ranges from $318 billion to $556 billion.

Responses to Changes in Demand or Payment Rates

Changes in payment rates could also have an indirect effect on spending by altering the number of services that providers would be willing to supply. Similarly, the budgetary effects of covering previously uninsured individuals would depend not only on

the resulting increase in their demand for care but also on how that increase affected the supply and prices of services. Because the number of U.S.-trained physicians that will be available to work over the next 10 years is largely fixed, supply adjustments in the short run would have to occur in other areas—which could include changes in the number of hours doctors worked or in their productivity, inflows of foreign-trained physicians, or changes in doctors' fees and patients' waiting times.

Whether and to what extent the supply of physicians and other providers would become constrained also depends on the size of the increase in demand for their services and the amount of time available for adjustments to occur. CBO's analysis indicates that providing the uninsured population with coverage that is similar to a typical employment-based plan would increase total demand for physicians' services and hospital care by between 2 percent and 5 percent. If payment rates rose in response to that increase in demand, the impact on spending could be larger. Spending on behalf of previously uninsured people would also increase to the extent that the uncompensated care they had received became compensated.

Uncompensated Care and Cost Shifting

Another issue that arises when analyzing payment rates is whether relatively low rates for public programs or the costs of providing uncompensated or undercompensated care to the uninsured lead to higher payment rates for private insurers—a process known as cost shifting. To the extent that such cost shifting occurs now, proposals that reduced the uninsured population or that switched enrollees from public to private insurance plans could affect private payment rates and thus alter insurance premiums. For that to occur, however, doctors and hospitals would have to lower the fees they charged private health plans in response to a decline in uncompensated care or an increase in their revenues from insured patients.

Overall, the effect of uncompensated care on private-sector payment rates appears to be limited. According to one recent set of estimates, hospitals provided about $35 billion in uncompensated care in 2008, representing roughly 5 percent of their total revenues.[3] Roughly half of those costs may be offset, however, by payments under Medicare and Medicaid to hospitals that treat a disproportionate share of low-income patients. Estimates of uncompensated care provided by doctors are considerably smaller, amounting to a few billion dollars, so the costs of providing such care do not appear to have a substantial effect on private payment rates for physicians.

Whether and to what extent payments to hospitals under Medicare and Medicaid fall below the costs of treating those patients is more difficult to determine. Recent studies indicate, however, that when payment rates change under those programs, hospitals shift only a small share of the savings or costs to private insurers (the same logic would apply for uncompensated care). Instead, lower payment rates from public programs or

3. Jack Hadley and others, "Covering the Uninsured in 2008: Current Costs, Sources of Payment, and Incremental Costs," *Health Affairs*, Web Exclusive (August 25, 2008), pp. W399–W415.

large amounts of uncompensated care may lead hospitals to reduce their costs, possibly by providing care that is less intensive or of lower quality than would have been offered had payments per patient been larger.

Administrative Issues and Effects on Other Programs

The extent to which proposals would affect health insurance coverage or federal budgetary costs, and the timing of those effects, would depend partly on the administrative responsibilities and costs that those proposals entailed and partly on their interactions with other government programs. Other factors would also affect coverage and costs, including the impact of any maintenance-of-effort provisions that might be applied to states or employers and the treatment of various segments of the population, including people who are ineligible for current government health programs and those who—although eligible—are generally difficult to reach and enroll.

Administrative Issues

Proposals could require both federal and state governments to assume new administrative responsibilities and could allocate those responsibilities to new or existing agencies. How well agencies fulfilled new missions—and how long it would take them to do so—would depend on the scope of the new responsibilities and the funding provided. Even with adequate funding, implementing a major initiative might take several years, as illustrated by the experience with the new Medicare drug benefit. One way to ease the implementation of a new federal program would be to build on existing programs; CHIP, for example, was implemented relatively rapidly because it largely built on the existing infrastructure of the state-operated Medicaid program.

Maintenance-of-Effort Requirements

A proposal that created new subsidies for health insurance could lead employers or states to scale back the coverage that they sponsor, particularly if a new federally funded program provided similar or more generous benefits. To prevent such responses or offset their effects on federal spending, proposals could include maintenance-of-effort provisions. Monitoring and enforcing such requirements for private firms would be difficult, however, unless proposals specified effective reporting mechanisms and sufficient penalties for violations.

States' maintenance-of-effort provisions are generally structured in two ways: requiring states to maintain existing programs at historical eligibility or benefit levels (as is done under CHIP), or requiring states to continue spending funds at certain historical or projected levels or to return some of their savings to the federal government (as is done for the Medicare drug benefit). The effectiveness of such requirements would depend on how they were defined, the enforcement mechanisms that were specified, and the incentives for states to comply. The provisions for CHIP and the Medicare drug benefit are examples of effective approaches.

Effects on Other Federal Programs

Proposals could also have unintended effects on eligibility for other federal programs that are not directly related to health care. New subsidies for health insurance might be counted as income or assets when determining eligibility for benefits in means-tested programs (such as the Supplemental Nutrition Assistance Program, formerly known as the Food Stamp program) unless explicitly excluded by law. Proposals that changed the employment-based health insurance system could shift compensation between wages and fringe benefits, thus affecting eligibility for government benefits (including Social Security) or tax credits (such as the earned income tax credit) that are based on cash earnings. Temporary or aggregate adjustments could be made to benefit formulas in order to minimize any adverse effects, but some recipients might still be made worse off.

Treatment of Certain Populations

The treatment of certain populations would present various administrative challenges for proposals to expand coverage. Some individuals, including military personnel and veterans, already receive health benefits from the federal government, and issues might arise regarding the coordination of their current benefits with new federal subsidies. In other cases, federal health programs currently deny benefits to certain populations, such as unauthorized immigrants or prison inmates, and proposals would have to specify whether and how those restrictions would apply to new programs. Other populations, such as the homeless, face challenges enrolling in existing programs, and similar issues might arise in designing new subsidies for health insurance. Those considerations would affect both the costs of proposals and their overall impact on rates of insurance coverage.

Changes in Health Habits and Medical Practices

In addition to any broader changes they make in the health insurance and payment systems, proposals could include specific elements designed to induce individuals to improve their own health or to encourage changes in how diseases are treated. Through a combination of approaches, proposals could try to change the behavior of both patients and providers by:

- Promoting healthy behavior, including measures aimed at reducing rates of obesity and smoking;
- Expanding the use of preventive medical care, which can either impede the development or spread of a disease or detect its presence at an early stage;
- Establishing a "medical home" for each enrollee, typically involving a primary care physician who would coordinate all of his or her care;

- Adopting "disease management" programs that seek to coordinate care for and apply evidence-based treatments to certain diseases, such as diabetes or coronary artery disease;
- Funding research comparing the effectiveness of different treatment options, the results of which could help discourage the use of less clinically effective or less cost-effective treatments;
- Expanding the use of health information technology, such as electronic medical records, which would make it easier to share information about patients' conditions and treatments; and
- Modifying the system for determining and penalizing medical malpractice.

Some of those initiatives could improve individuals' health or enhance the quality of the care that they receive, but it is not clear that they also would reduce overall health care spending or federal costs. In its analysis of such initiatives, CBO considers the available studies that have assessed the particular approaches. In many cases, those studies do not support claims of reductions in health care spending or budgetary savings.

Challenges in Demonstrating Savings

For several reasons, it may be difficult to generate reductions in health care spending from such initiatives. In some cases, the problem is largely one of identifying and targeting the people whose participation would cause health care spending to decline. Broad programs aimed at preventive medical care and disease management could reduce the need for expensive care for a portion of the recipients but could also provide additional services—and incur added costs—for many individuals who would not have needed costly treatments anyway. To generate net reductions in spending, the savings that such interventions generated for people who would have needed expensive care would therefore have to be large enough to offset the costs of serving much larger populations.

A related issue is that many individuals or health plans might already be taking the steps involved (or will in the future) even in the absence of a new requirement or incentive. The effect of any proposal would have to be measured against that trend, and a large share of any subsidies involved might go to people who (or health plans that) would have taken those steps even if there were no requirements or incentives to do so. For example, some doctors and hospitals are already using electronic medical records, and more will adopt that technology in the future under current law, so new subsidy payments would go to many providers who would have purchased such systems anyway, and savings would accrue only for those providers who accelerated their purchases as a result of the subsidy.

In other cases, the effect on health care spending depends crucially on whether doctors and patients have incentives to change the use of health care services. For example, studies may find that a given treatment has fewer clinical benefits or is less cost-effective (meaning that added costs are high relative to the incremental health benefits) for certain types of patients—but those results may not have a substantial effect on the use of that treatment unless the financial incentives facing doctors (through their payments) or patients (through their cost sharing) are aligned with the findings. Similarly, proposals to establish a medical home may have little impact on spending if the primary care physicians who would coordinate care were not given financial incentives to limit their patients' use of other health services.

Other types of initiatives might ultimately yield substantial long-term health benefits but might not generate much savings, at least in the short term. Even if successful, measures to reduce smoking and obesity—two factors linked to the development of chronic and acute health problems—might not have a substantial impact on health care spending for some time. In the long term, spending on diseases caused by poor health habits could decline substantially, but the impact on federal costs would also have to account for people living longer and receiving more in Medicare benefits (for the treatment of other diseases and age-related ailments) as well as other government benefits that are not directly related to health care (including Social Security benefits). Similarly, investments in health information technology might require substantial start-up costs that would be difficult to recapture in the typical 5- and 10-year budgetary time frames used to evaluate legislative proposals.

Demonstrating savings might also be difficult because of data limitations and methodological concerns. For example, studies have found that tort limits, by reducing malpractice awards, cause premiums for malpractice insurance to fall and thus could have a very modest impact on doctors' fees and health care spending. Some observers argue that tort limits would yield larger reductions in that spending because doctors would stop ordering unnecessary tests and taking other steps to reduce the risk of being sued. CBO has not found consistent evidence of such broader effects, but that may reflect the difficulty of disentangling the impact of changes to the medical malpractice system from other factors affecting medical costs.

Related Budget Options

In its *Budget Options* volume, CBO estimated the effect of several approaches aimed at changing health habits or medical practice. For example, Option 106 would impose a new excise tax on sugar-sweetened beverages (equal to 3 cents per 12 ounces of beverage), which would raise about $50 billion in revenues from 2010 to 2019. CBO did not, however, estimate that spending on health care would be reduced under that option. After evaluating the available evidence, CBO could not establish causal links between lower consumption of sugar-sweetened beverages (which would occur under the option) and the use of health care. Studies indicate, for example, that people would offset the reduction in their consumption of such beverages with increases in consumption of other unhealthy foods—so the impact on obesity rates is not clear. In

addition, even though obesity is associated with higher spending on health care, the effect of losing weight on spending for health care is more difficult to determine.

CBO also analyzed the effects of establishing a "medical home" for chronically ill enrollees in the Medicare fee-for-service program (see Option 39). As designed, that option would increase Medicare spending by about $6 billion over 10 years because of the fees provided to practitioners who elected to become medical homes. Alternatively, approaches that would give primary care physicians a financial incentive to limit their patients' use of expensive specialty care—such as the option imposing partial capitation, discussed above—could reduce Medicare spending (depending on the specific features of their design). In the realm of preventive medical care, CBO analyzed the impact of basing Medicare's coverage of such services on evidence about their effectiveness (see Option 110). That option would save nearly $1 billion over 10 years because it would lead the Medicare program to drop coverage for services that are currently covered even though an independent task force has recommended against their use (reflecting evidence that the preventive services are either ineffective or do more harm than good).

Under Option 45, the federal government would fund research that compares the effectiveness of different medical treatments. The results of that research would gradually generate modest changes in medical practice as providers responded to evidence on the effectiveness of alternative treatments, the net effect of which would be to reduce total spending on health care in the United States; the resulting reductions in spending for federal health programs would partly offset the federal costs of conducting that research. Option 8 would impose specific limits on medical malpractice awards; the resulting reduction in premiums for malpractice insurance would yield reductions in the federal budget deficit of nearly $6 billion over 10 years. (CBO did not conclude that the option would have broader effects on the use of health care services.)

Finally, Options 46 through 49 provide various approaches to increase the adoption of health information technology and electronic medical records. Option 46 would create incentives under the Medicare program to adopt that technology; the primary effects on federal outlays would stem from the payment of bonuses for adopting it or the collection of penalties for not doing so. Option 47 would require doctors and hospitals to use electronic health records in order to participate in Medicare. CBO judged that virtually all doctors and hospitals would adopt electronic health records as a result, reducing the federal budget deficit by about $34 billion over 10 years (or by a larger amount if Medicare's payments to doctors and hospitals were also reduced to capture the resulting gains in their productivity).

Effects on Total Health Care Spending, the Scope of the Federal Budget, and the Economy

Proposals that would substantially change the health insurance market could affect total spending on health care, the flow of payments between various sectors of the economy, and the operation of the U.S. economy. CBO will consider those effects in its analyses of major health care proposals.

Effects on Total Spending and the Scope of the Federal Budget

Many health insurance proposals would have an impact on total spending for health care, and some might contain provisions that explicitly limit the level or rate of growth in health care spending; such proposals might impose a global budget or budgetary cap on all or a part of that spending. The effectiveness of such strategies would depend on several factors, including the scope of the global budget, the targets selected for different categories of spending, and the mechanisms used to enforce the caps.

In addition to their overall effects on federal spending and revenues, proposals that made substantial changes to the health insurance system or its financing methods could raise a number of budgetary issues. Such proposals could have substantial effects on the flows of payments among households, employers, and federal and state governments—even if the proposals were budget neutral from a federal perspective. Some proposals might assign the federal government a more active role in the health insurance market; for example, the government could be required to disburse subsidies covering the cost of health insurance, collect health insurance premiums from policyholders, or make payments to insurers. Any of those changes might raise questions regarding who—the government, the insured, or the insurer—would bear financial responsibility for any shortfalls in payments that might occur.

Other proposals might require that individuals or businesses make payments directly to nongovernmental entities. Depending on the specific provisions of such proposals, CBO might judge that payments resulting from federal mandates should be recorded as part of the federal budget even if the funds did not flow through the Treasury. The extent of federal control and compulsion is a critical element in determining budgetary treatment. In general, CBO believes that federally mandated payments—those resulting from the exercise of sovereign power—and the disbursement of those payments should be recorded in the budget as federal transactions.

Effects on the Economy

Proposals that made large-scale changes affecting the provision and financing of health insurance could also have an impact on the broader economy. Because most health insurance is currently provided through employers, proposals could affect labor markets by changing individuals' decisions about whether and how much to work and employers' decisions to hire workers. Such effects could arise in several ways:

- Proposals that decreased the return from an additional hour of work, by imposing new taxes or phasing out subsidies or credits for health insurance as earnings rise, could cause some people to work fewer hours or leave the labor force.

- Proposals that made health insurance less dependent on employment status could induce some people to retire earlier and others to change jobs more often.

- Proposals that treated firms differently on the basis of such characteristics as the number of employees or average wages could affect the allocation of workers among firms.

- Proposals that required employers to provide health insurance could adversely affect the hiring of employees earning at or near the minimum wage, because the total compensation of those workers could exceed their value to the firm.

Some observers have asserted that domestic firms providing health insurance to their workers incur higher costs for compensation than do competitors based in countries where insurance is not employment based and that fundamental changes to the health insurance system could reduce or eliminate that disadvantage. Although U.S. employers may appear to pay most of the costs of their workers' health insurance, economists generally agree that workers ultimately bear those costs. That is, when firms provide health insurance, wages and other forms of compensation are lower (by a corresponding amount) than they otherwise would be. As a result, the costs of providing health insurance to their workers are not a competitive disadvantage for U.S.-based firms.

In addition to their effects on the labor market, proposals could also affect the size of the nation's stock of productive capital, especially through their effects on government budgets. Those effects would depend partly on how the costs of any insurance expansions or other changes were financed. The net effect on the economy of a broad proposal to restructure the health insurance system would, not surprisingly, depend crucially on the details.

Chairman CONRAD. Thank you. Dr. Elmendorf, thank you for your testimony. I want to get to a point that has really struck me ever since I began studying health care, and that is, about 5 percent, roughly 5 percent of the Medicare population uses half of the budget. So roughly 5 percent, maybe a little bit more than that, depends year to year, use half of all the money, and they are the chronically ill.

When I went to business school and you found a statistic like that, you know, you focused on it like a laser. Half the money going

to only 5 percent of the patient base. And a number of years ago, they did a study with about 20,000 patients. They put a case manager on every one of the cases. These are people that are chronically ill. They have multiple serious conditions. And they found by that simple act they dramatically reduced the number of prescription drugs they were taking, they dramatically reduced hospitalization, they dramatically reduced the number of duplicate tests that patient population was subjected to, and they saved substantial amounts of money and got better health care outcomes.

When we did the Medicare prescription drug bill, I tried to get funding to dramatically ramp up the number of people, because what we do not know is it works with 20,000 patients, but what happens when you go to 250,000—which is what I wanted to see tested. Can we manage that?

Have you looked at this whole question of care coordination? And what is your assessment of how rich the ore is there to be mined?

Mr. ELMENDORF. I think the ore is potentially very rich. You are exactly right about the distribution of spending. A small share of beneficiaries are responsible for a large share of all Medicare spending. Of course, this is true in health insurance in general. Most people get through a year needing very little medical care, and some need a great deal of medical care. So a certain amount of that skewness in the distribution of benefits is natural in health insurance, but it does raise the possibility that better management of the care for those people could substantially reduce health spending. And there are instances, as you note, where reductions in spending have been considerable.

But as you say, the challenge is trying to apply that on a broader scale. That means several things. Part of it is to empower providers to manage patients' overall care. So it means—for example, in our review of possible options for health care reform, we talk about bundling of post-acute care with care given in hospitals in terms of Medicare's reimbursement. So currently Medicare will reimburse a hospital for a patient, but when the patient leaves the hospital, then other providers will submit separate claims for reimbursement. So it is possible that bundling the original services, the original acute care services and the post-acute services under one bucket with one reimbursement would then empower the hospitals presumably to manage that care in a better fashion.

So we have to empower providers to have that influence over patients' overall care, but then we also need to be sure that the Federal Government provides incentives for those providers to, in fact, economize on care. So coordinating care better is almost certain to improve health. Whether it saves money in the Nation as a whole, or the Federal Government, depends on whether there are specific incentives in the coordination to economize unnecessary services and for the Federal Government to capture some of the savings from that.

Chairman CONRAD. Let me just say this study that was done is very interesting. The first thing they did is go into people's homes, get all the prescription drugs out on the table. On average, they found these people were taking 16 prescription drugs. And after a review, they were able to cut it in half.

I went through this same exercise with my father-in-law, and sure enough, we get around the kitchen table, and he was taking 16 prescription drugs. We get on the phone to the doctor, and we were able to cut it in half. And I said to the doctor, "How does this happen?" He said, "You know, Kent, he has got a heart specialist, he has got a lung specialist, he has got an orthopedic specialist, he has got me as a family practice doctor. Everybody is prescribing. He is getting drugs from the corner pharmacy, from the hospital pharmacy, from the pharmacy at the beach, he is getting them mail order. He is sick and confused. His wife is sick and confused. We have got chaos." And chaos costs money.

Mr. ELMENDORF. One very important aspect of Medicare, which is really done on a fee-for-service basis now in most cases, is physicians, and it is exactly what you say. My mother is a Medicare patient with a large collection of specialists and a large collection of overlapping treatments. And finding a way to make the physicians work together both to improve health and save spending is the challenge. And we review some options in these books about organizations to do that. We call them "bonus-eligible organizations." They are sometimes called "accountable care organizations." They are groups of physicians. A medical home is an idea where a primary care physician would be the principal doctor. You are one's medical home, if you will. And that physician then has more responsibility and potentially has some financial incentive for ensuring that you see just the doctors you need and have just the tests that you need.

Again, that has the potential of improving health and reducing costs, but these ideas have not been tried very widely, and that is why it is unclear which specific ones will be most effective, even though I think there is a general consensus about moving in this direction.

Chairman CONRAD. It seems to me that it is just common sense that if you have got everybody in different silos and you do not have care coordination, things are going to be far more expensive. And, frankly, about the last thing somebody who is sick wants to do is a bunch of duplicate tests and duplicate visits to doctors' offices. That is not in anybody's interest.

I have very little time left. Let me just ask with respect to—I have always been intrigued by the German system. Maybe that is because I am part German. But I have always been intrigued by their system, which is, as I understand it, you get the coverage largely based on where you work; it is employment related. People are put in large purchasing pools so they have leverage in the negotiation to get good rates. And the government's role is to make certain that those who could not be otherwise covered, their employers are too small or the people have insufficient income, that is the government's role. But that is the limit of the government's role.

Have you studied that system at all? And what is your assessment of it, if you have?

Mr. ELMENDORF. I have not studied that system carefully, and I do not know if CBO has. I think the issues that you raise are the key issues, which are: How do you pool people and what sorts of subsidies are provided to whom? But in addition to the financing,

there is also this very important question about how health care is delivered. And you noted yourself tremendous variation across regions of this country in terms of the way physicians and hospitals practice medical care.

The reasons for the differences across regions are not completely clear, and what it is that works and does not work in certain places is not completely clear, and that is the difficulty in squeezing that out. Other nations do spend much less on health care as a share of their GDP than we do, without suffering evident deterioration in their health. But it is separating the wheat from the chaff in health care that is a key challenge.

Chairman CONRAD. Thank you.

Senator Sessions.

Senator SESSIONS. Thank you very much.

Dr. Elmendorf, thank you for your foresight and for laying the groundwork for developing the information that will help this Congress deal with one of our biggest crises, which is health care. I do not think the present system is working. I do not think it is working well. But I have to tell you that I do not know how to fix it.

Senator Wyden has got a very promising idea. He has talked to me about it. Others have ideas. And so it is something we have got to wrestle with.

Just to tie down those numbers, I see that health care premiums have gone up 78 percent between 2001 and 2007, whereas workers' earnings have risen only 19 percent. It seems to me, would you not agree, that that is an unsustainable trend?

Mr. ELMENDORF. Yes, sir.

Senator SESSIONS. And looking at your charts—and Senator Conrad has talked about this over the years, but just with regard to Medicaid and Medicare, Medicaid over 75 years is projecting a $36 trillion shortfall. Is that right?

Mr. ELMENDORF. That sounds right, yes.

Senator SESSIONS. And Medicaid, a $16 trillion shortfall, so a $62 trillion shortfall there. If something does not change, the taxpayers will have to just pick that up by higher taxes and more payments into the system. Is that fundamentally correct?

Mr. ELMENDORF. That is right. As long as health spending is growing faster than GDP, then it will continue to soak up an ever increasing share of our output and an ever increasing share of the Federal budget.

Senator SESSIONS. Which diminishes the amount of money that families would have for housing, for clothing, for schooling, for automobiles, and everything else.

Mr. ELMENDORF. Yes.

Senator SESSIONS. This is an unhealthy trend, I guess you would agree.

Mr. ELMENDORF. Critically unhealthy, yes.

Senator SESSIONS. With regard to the physicians and their reimbursement rate, would you agree that they have a legitimate concern that they need certainty in their future? And do you happen to have the numbers close by as to what it costs this year to fix their reimbursement rate to keep it from falling as compared to what would happen if Congress does not act? I think we have got

about a 20-percent expected reduction in their payments next year if we do not act.

Mr. ELMENDORF. There will be a 21-percent reduction in this coming year, and then 5-percent reductions annually for years to come. One of the options that CBO addresses—or a set of options as ways of adjusting that, if one were to eliminate the sustainable growth rate mechanism, this feature of the law, and hold beneficiaries harmless from the increases in premiums, that would cost $556 billion over the next 10 years.

Senator SESSIONS. Well, that is a stunning number, and that is obviously why we have not put it in the budget. We hope it will go away, but fundamentally it is not going away unless we do develop some new processes for containing costs. And I hope that we can.

You talk about your analysis. I would suggest—and maybe you can elaborate on it. You are concerned about unintended consequences and things that might appear to result in X may result actually in X plus Y. Tell me about, let us say, preventive medicine. There is a belief that we can save considerable amounts of money by investing more in preventive medicine.

Now, I fully recognize that preventive medicine can make the quality of a person's life better and maybe their employment better. But with regard to actual reduction of cost, is there some doubt about that how much it would reduce cost?

Mr. ELMENDORF. On your general point, Senator, the health care delivery system and the health care financing system are both incredibly complex, and changes to any part of those systems could reverberate through the systems in ways that are very difficult for analysts like those at CBO to anticipate. I think that is a legitimate concern in approaching health care reform.

On preventive medicine, there seem to be some forms of preventive medicine that are cost-effective—we should do more of them—and others that are not cost-effective, and we should not necessarily do more of them.

Senator SESSIONS. When you say cost-effective, are you considering the benefit to a person's health or are you just saying the total net cost to the Government is not a savings or it might be some savings?

Mr. ELMENDORF. I meant cost-effective including the effects on people's health. Obviously, it is hard to value that. But as experts have looked at a range of medical care and a range of preventive services, it seems there are some things that we are just not doing enough of relative to their benefit/cost ratio and others that we should be doing much less of.

Senator SESSIONS. And we have data that would help us make that decision already, or do we need more data?

Mr. ELMENDORF. We have those data for some preventive services and not for others. There is a whole list of possible preventive services for which the experts, the task force simply throws up its hands and says we do not know enough yet about the value. I will mention one specific example: flu shots for older Americans. It is recommended for older Americans to get flu shots. Well less than half get them. If you were to get flu shots to virtually all older Americans, that would prevent a number of people from getting the

flu and having very serious consequences, but it would be expensive because you have to give shots to a lot of people who do not now get shots.

So there are some direct savings in terms of the care. There also is some offsetting costs in terms of giving the shots. That direct offset is about a third of the financial—now this is a financial benefit to the Government calculation. There are some direct savings to Medicare by not having to provide intensive care for people who get the flu. About a third of that is offset by the extra cost of giving people the flu shot. And, moreover, just from a purely financial point of view, people who do not get the flu live to get other disease and maybe die from the other diseases. So there are indirect costs to Medicare down the road because somebody who is saved from the flu today can live several more, hopefully healthy, years but might get sick with something else inside the 10-year budget window.

So the 10-year budget savings are essentially zero, even though it is a very effective means of increasing health. And that is one of the examples of how it is that things that are good to do by a whole range of metrics do not necessarily address the Government's budget problem.

Senator SESSIONS. Information technology is likewise potentially beneficial, but perhaps not as much as some have expected and had hoped to see?

Mr. ELMENDORF. CBO believes that over time essentially all providers will have health information technology at their fingertips for patient records, for electronic prescribing, for guidance in their clinical decisions. The proposals that have been on the table are generally to accelerate—to provide penalties or bonuses to encourage providers to accelerate that adoption.

We think that would have some beneficial effects on health and would save the Government some money. I think the biggest possible savings come from combining that sort of technology with incentives to use it in a way that reduces excess utilization of care and coordinate care and so on. So it really is the—as I said in my comments, the information is very helpful, but would be much more helpful if it comes with incentives to use it in certain ways.

Senator SESSIONS. Well, I hope that we can—I think it is inevitable and necessary that we move to that, and I think it has the potential to avoid misprescribing of drugs and other things.

Mr. Chairman, I would agree with you. In my personal family, my mother and her sister, when you get them back with the doctor and sit down, they make a lot of changes, often reducing medicines and coming out with better results. So that is, I am sure, a true picture of some of the errors we are making in health care.

Thank you.

Chairman CONRAD. Thank you, Senator Sessions.

I am going to turn to Senator Wyden, but before I do, I just want to say how much I appreciate the exceptional work that Senator Wyden has done on health care reform. I think his group now is 13 Senators, about evenly divided between Republicans and Democrats, who have come together around a comprehensive health care reform proposal and one that is fiscally responsible and one that

scores that way with the Congressional Budget Office, which is a rarity around here.

So, Senator Wyden, thank you for your very good work.

Senator WYDEN. Mr. Chairman, thank you for your kind words, and let me also pick up on a point you made in your opening statement, and that is, Chairman Conrad indicated that it is important to be cautious about the idea of going out in this health reform debate and spending vast sums of new money right out of the gate. And, boy, I sure share your view.

We ran the numbers, Dr. Elmendorf, with the CBO figures. You all indicated that we are going to spend $2.5 trillion this year on health care. There are 305 million of us. If you divide 305 million into $2.5 trillion, you could go out and hire a doctor for every seven families in the United States. You could hire a doctor for every seven families, pay the doctor $235,000 and say, "Doctor, this year your job will be to take care of those seven families." Whenever I bring this up with the physicians, they say, "Where could I go to get my seven families?" Because it is obvious, as Chairman Conrad pointed out, we are spending enough. We are not spending it in the right places.

Let me, if I might, going again to the CBO budget books, unpack, I think, the best ways to find money quickly to responsibly pay for health reform. And in your budget options, 9, 10, and 11 deal with the Federal tax rules. This is the biggest sum of money that is being spent on health care today, just under $250 billion. It rewards inefficiency and disproportionally favors the most affluent.

Now, my first question to you is I note that not only does CBO score this as making substantial savings, but on page 5 of your testimony this morning, you say something that I have not seen before, which is that the savings from modifying the Federal tax code would actually grow in the years ahead.

Could you amplify a little bit on that? Because I thought I had been scouring the books on this point, but I think that is really something of a breakthrough, because your original document showed it makes substantial savings, and now today you are arguing that it will save even more down the road?

Mr. ELMENDORF. Senator, you are right about the size of the tax expenditure, if you will. The exclusion of employer-paid health insurance from income taxes costs the Government about $145 billion currently, and the exclusion from payroll taxes costs the Government about $100 billion currently. Those numbers are larger as one looks down the road. This is not something that we invented now, although perhaps we brought it to a wider attention. All tax provisions grow to some extent over time because the economy grows and prices rise. But the value of this exclusion grows with health care spending over time. So our estimate of the value of this provision, I think more specifically the way the Joint Tax Committee estimated some of these options, has it growing over time with health care spending, because whatever employers end up putting into health insurance does not count as taxable income.

Senator WYDEN. I asked Dr. Orszag this, but because this is your first appearance here, I feel compelled to ask you as well. The President made two pledges in his campaign that it seems to me in the health area bring Democrats and Republicans together. And

we do have seven members of this Committee as cosponsors. We are working with Chairman Kennedy and Chairman Baucus; Senator Alexander is a cosponsor—a number of colleagues on both sides of the aisle. And the President said, one, he wants to make sure that everybody can keep the coverage they have, and we have that actually in a section called "Guaranteeing you can keep the coverage you have." The second is he said that he wants to make sure middle-class people do not get clobbered with new taxes on their health care.

Based on my analysis and what Dr. Orszag has said, it would be possible to keep both of the President's pledges in a bipartisan bill and, based on your figures in 9, 10, and 11 of the CBO option report, still have a substantial amount of new money available for health reform. Do you share Dr. Orszag's view on that point?

Mr. ELMENDORF. I agree with Peter that, in principle, one can use the pool of money generated by these exclusions from payroll and income taxes and increase health insurance coverage very substantially. But I want to be clear. Options 9, 10, and 11 in our book lead to reduced insurance coverage that in those options there are substantial budget savings, but actually less insurance coverage.

Now, one can vary the parameters one chooses. The issue here is that as one restricts the exclusion by taxing that compensation in some way, one then raises the relative cost of health insurance. That is the idea in many people's minds. That is what makes people then scrutinize health spending more carefully because it is more an apples-to-apples comparison with other goods they might want to buy. But it is also true that raising the relative cost of health insurance induces some people not to buy health insurance unless there are other forms of subsidy provided or mandates or something else.

So those options alone do not accomplish your objective, but there are other options I think one could pursue that would expand health insurance coverage and not do so on the——

Senator WYDEN. That is a fair point, and it also fleshes out the score that the Chairman referred to for our legislation, because in our legislation not only do we let people keep what they have, we have written it so that everyone would be able to get a mid-range Federal employee package, and that would be a guarantee because of other savings. What I have tried to do, what you have confirmed in principle, is that there is such a large amount of money there in the Federal tax rules that you do free up a substantial amount for expanding coverage, and I appreciate your characterization. You are not here to testify on particular bills, and Dr. Orszag was not either. But, in principle, there is enough money to expand coverage.

One last point, and that is on this question of purchasing health care more efficiently. I think as you get into this, there are really kind of three parts to this. One is you have to have a data base that in some way is in a position to look at the behavior of health care providers. Second, you have to do what President Obama is doing, which is to set in place a system of electronic medical records. But at the third level, you have the really difficult, painful judgment, which is at some point Medicare and the private sector cannot reimburse for expensive services that are not of much value.

Those strike me as the three pieces of a strategy to squeeze out the inefficiency.

I would like your reaction on that and any other thoughts about what it is going to take to make the system more efficient.

Mr. ELMENDORF. I agree with and I think most analysts would agree with your emphasis on information and on incentives, and the information serves a number of purposes, as you mentioned. Part of it is to ensure that if an individual doctor is treating a patient, he or she can see what else has been done to that patient—what other drugs they may be on, what other doctors they have seen, what other tests they have had. Also, technology that stores and makes information available can provide guidance to doctors. It is called "Clinical Decision Support." So if a patient presents to a doctor with certain characteristics, the doctor can get some guidance from the system in many cases about what treatments might be most effective.

Technology is very important, but I think you are absolutely right, one needs incentives to go with that. The challenge with the incentives—as you said correctly, you do not want to reimburse for procedures that are not useful or beneficial. The challenge is we do not know what procedures are most beneficial, on average. And even if we did, or when we do, we will not know who they are most beneficial for. There are very few medical procedures that are good for nobody. It is not a case that there is a whole branch of a hospital which never does any good for anybody. The problem is that there are procedures that will be useful, and particularly cost-effective, for some people in some circumstances and not for others.

So it is distinguishing—it is much more complicated than saying Medicare will not pay for something and will pay for something else. It is trying to set it up so that Medicare pays in the cases when it is useful and not when it is not. And that is a much harder set of rules to write. It is always changing. We have new procedures, we have new learning about what works and does not work. And ultimately mistakes will be made. There will be people—one can say this procedure is not worth doing because it only helps 1 in 100 people and it is very, very expensive. So a cost/benefit calculation says that is not worth doing, we can improve health more by wellness programs or something else. But if you are the 1 in 100, that is not going to be much consolation, and that kind of choice is very difficult.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Welcome, Dr. Elmendorf.

Mr. ELMENDORF. Thank you, Senator.

Senator BUNNING. I want to get on health information technology. It seems to make sense from a quality and efficiency standpoint. Many people seem to argue that it will save the health care system a lot of money. In the book "Key Issues in Analyzing Major Health Insurance Proposals," CBO seems skeptical, at least, that substantial cost savings will occur. Can you walk us through what the potential benefits and shortfalls are of implementing health information technology, especially from the cost perspective?

Mr. ELMENDORF. In the options that CBO has estimated the budgetary effects of, there are savings to the Government, but as you are noting, the bulk of those savings come from the penalties themselves. So the way these options work is that there might be some bonus for adopting health information technology soon and a penalty for not adopting it. And the biggest budgetary effects come from the bonuses that are paid or the penalties that are collected. The savings from reducing unnecessary utilization of health care are comparatively small, and I think the principal reason for that is that providing the technology by itself does not ensure that the technology is used effectively. And one needs to combine the technology with incentives to make cost-effective decisions if one wants a cost-effective outcome.

I think there are other issues, I should say as well. Although a lot of work has been done in developing health information technology, we are not at the point where we know how to move the data around quickly and efficiently enough. There is development work underway, but it will take some time.

There are places, for example, the Veterans Administration's hospitals, where health information technology has been used to very strong positive effect, but applying that—the VA system is a closed system, a particular set of rules. Applying that broadly across the whole medical profession with all the variation will take time to figure out as well. So some of that is delay, and some of that I think is needing the incentives as well.

Senator BUNNING. Being from a very rural State—Kentucky—some of our doctors think that information technology is the savior on cost reduction, because we only have like three or four major centers of hospitals. So the transfer of information between critical care centers in the rural areas and the major hospitals in either Louisville in northern Kentucky or Lexington or Owensboro, for instance, they argue the fact that if we could transfer the information back and forth quickly, we could reduce the costs dramatically.

What do you say to that?

Mr. ELMENDORF. I think that is quite possible. I think that is an important use of health IT that I did not mention, but I think it is an important one. The problem that CBO faces in putting numbers in a book like this is that we have to rely on evidence from cases where certain changes in health care have been used, and there are a lot of possible changes, and some things have been tried, but many have not been tried, or have not been tried in the combination that people are thinking about them.

So the fact that we score something having a certain value, it does not mean that we know that is the effect. In many cases, the uncertainty that we face is very large, and I think there are cases, as you suggest, where there may be benefits that we have not incorporated. There may be other cases where some studies have been very positive in ways that will turn out not to be transferable to other contexts, and we will get less savings than we have written down.

Senator BUNNING. OK. As the cost of health care increases, so do the number of uninsured. CBO estimates that the number of uninsured will reach 54 million by the year 2019. Today there are about 45 million.

With this increase in the uninsured, what will the impact be on the Federal and State health care programs?

Mr. ELMENDORF. That is our estimate of people who will end up without insurance. There are people who will be—over this next decade who will lose employer-sponsored insurance and who will move on to Federal programs or Federal/State programs directly. The uninsured receive care about 60 percent of as much care as people who are insured in this country, and those costs are borne in some different ways. Part of that is that we make payments from Medicare and Medicaid to hospitals with a disproportionate share of patients who do not have insurance. Another part of the way those costs are borne is that hospitals economize on their services that they provide, on the amenities they provide. And there is another small piece, analysts estimate, that is borne by private insured patients.

So I think the bulk of the extra cost will be taken up by hospitals in ways that involve some reduction of services and some reduction of amenities.

Senator BUNNING. Don't you think those with private health care insurance pay up the difference to help cover those that are uninsured?

Mr. ELMENDORF. There is certainly a logic to that, but the evidence suggests that that cost shifting is comparatively small. In fact, hospitals are charging private payers all they can charge them anyway, and——

Senator BUNNING. Yes, I know they are.

Mr. ELMENDORF. And so that——

Senator BUNNING. From experience.

Mr. ELMENDORF [continuing]. Changes in the government payments, for example, to providers, to hospitals under Medicare, changes in those payments don't seem to have a strong effect on the payments the private insurers make for the hospitals. So from that evidence, it seems that changes in uncompensated care would have some effect, but not the predominant effect on private insurance.

Senator BUNNING. Last question. In terms of health care reform, many people are advocating for a law mandating health coverage as a way to ensure everyone is covered. From CBO's perspective, would mandating health care insurance lead to universal health care coverage?

Mr. ELMENDORF. No. I was very careful in my testimony to use the phrase "near universal coverage" and to say that accomplishing that requires, I think in the view of all analysts, a combination of approaches, pooling of risks, subsidies in some form, and either a mandate or processes to facilitate enrollment. So even the combination of those will not lead to truly universal coverage because people slip through the cracks of systems. And any one piece of those proposals is not likely to lead to even near universal coverage.

Senator BUNNING. Thank you, Doctor.

Mr. ELMENDORF. Thank you, Senator.

Chairman CONRAD. Thank you, Senator Bunning.

Next, we will go to Senator Whitehouse. Before we do, I just want to say that Senator Whitehouse comes to this committee with considerable experience in dealing with health care funding crisis

at the State level and that experience has already been of considerable help to this committee. Senator Whitehouse?

Senator WHITEHOUSE. Well, thank you, Chairman, and what a beautiful segue to my question, which was going to have to do with our relationship with you. During one of the reforms that I managed in Rhode Island, we had an actuarial firm looking over our shoulder so that we could quantify the savings that we needed to take out of a system. In my experience, there were things that the actuarial firm recommended because they could quantify them, because actuarial science lends itself to the calculation of that particular mode of reform. And there were other things that they couldn't evaluate.

And we had to make a policy decision, and in one case, we decided to not go the path where they could quantify the reform because we just felt it wouldn't work, and instead we did something that they gave us literally zero credit for. And they said to us, look, you are probably doing the right thing here, but because we don't have that experience you talked about, because we can't look back at proven evidence, we are disabled from telling you officially that this will work.

And what I worry about is that we are headed into, I think, a fiscal crisis that is going to make the current economic problem look like a picnic. I mean, if you look at $35 trillion in unfunded Medicare liability bearing down on us inevitably, and we are fighting now over a $700 or $800 billion bill as if that were the end of the world, $35 trillion is just enormous and we have to get after that.

I have two concerns about your actuarial science. One, there is a limited amount of evidence, and so you are very limited in what you can sign off on in terms of scoring. And two, areas that we have been talking about, like health information infrastructure and investment in quality reform that saves money and reimbursement reform, end up being dynamically inter-engaged.

We had a witness who came here and said—used an example of a toaster. You test putting the toast in the toaster and you take it back out. It didn't work. You test putting the lever down. It didn't work. You test plugging it in. It didn't work. Nothing made toast. Nothing will work. But if you plug it in and put the toast in and then push it down, boom, toast.

So there is a second worry, which is that it is very hard for somebody in your position with the professional restrictions that you have to operate under to try to quantify those dynamic interactions that can make the difference between an information technology system that just sits on doctors' desks and another one that saves potentially, according to RAND, $350 billion a year.

What do we do about that? And does there need to be some new entity of some kind establishment that can provide the kind of dynamic oversight that we need for these dynamic interactions between the different types of solutions necessary to turn this around in the short period of time before the $35 trillion hits us and then we are in trouble that makes today's troubles look like they are troubles in a minor key? I count on you through this, and how much do your limitations make you a partner but not a complete guide in all of this?

Mr. ELMENDORF. I agree entirely with your concern, Senator. CBO is going to draw on existing evidence about the effects of changes and that evidence will be weak in many cases, and it will be particularly weak in cases that involve the interactions of several policy changes.

We have a fair amount of evidence related to incremental changes on policies that have been in place for a long time, because almost everything has been moved up and down and you can see how the world has responded to that. We have very little evidence about interlocking changes in the complex health care system. I don't think that our numbers should be the ultimate determinant of the policies that you and your colleagues will vote for and against.

Senator WHITEHOUSE. We will have to make some leaps of faith based on our best judgments.

Mr. ELMENDORF. Yes. Now, however, let me say I think we can be of great service to you in judging what leaps are worth taking.

Senator WHITEHOUSE. Yes.

Mr. ELMENDORF. There are leaps the faith that lead the people falling into the chasm and there are leaps of faith that have at least a passing chance of grabbing hold on the other side. Our expertise, I think, can be very valuable to you in judging what leaps to take.

As I said, I think there is a fairly broad consensus about some of the overall direction that the health care system should move in to make it more effective and cost efficient. Much less agreement about specifically what steps will do that. Is it medical homes? Is it accountable care organizations? Is it greater bundling of hospitals' care and post-acute care? Is it health IT? Is it—there is a whole list of these possibilities. I think there is a tendency in discussions of health care to view one of them as a silver bullet or to dismiss it as a failure because it is not the silver bullet.

I think, in fact, most analysts believe that we need to try a set of policies. Some will be duds or even counterproductive. Others will turn out to be more effective than we anticipate. And that trying, though, will mean doing things that we—some of those things we should anticipate will fail, and that is this leap of faith that I think needs to be taken. But again, choosing what leaps to take, I think, we can be very important. Not all leaps are the same, and how far you leap and choosing ways of doing demonstration projects and changes to have a long-run goal—which is a quite different system perhaps, but moving there incrementally so that indirect effects on the rest of the system can be evaluated—are ways of reducing the risk associated with those leaps.

Senator WHITEHOUSE. And if you are going to not only take those leaps, but then have to manage and evaluate them to see which ones were productive and which ones were not, and if you are looking at delivery system reform across the health care system and not just isolating Medicare and Medicaid patients, where presently in the U.S. Government is there an authority that can effectively oversee that set of dynamic changes on a going forward basis?

Mr. ELMENDORF. So I think the changes in Medicare are important, not just for their—not just because Medicare itself is a large program——

Senator WHITEHOUSE. No, no, trying to do it systemwide and reach beyond Medicare and Medicaid.

Mr. ELMENDORF [continuing]. But also, I think, as an example that it sets in two levels. One is that physicians who adopt health IT because Medicare makes them for Medicare patients will use it——

Senator WHITEHOUSE. I have got 22 seconds left——

Mr. ELMENDORF [continuing]. For other——

Senator WHITEHOUSE [continuing]. So I would love to have this discussion with you, but let us assume the premise of my question, which is that we are trying to do a delivery system reform that goes outside of just the Medicare and the Medicaid patient. Do we presently have an authority in government that can oversee the dynamic process of engagement?

Mr. ELMENDORF. No.

Senator WHITEHOUSE. OK. Thank you.

Chairman CONRAD. Senator Alexander is next, and before he starts his questioning, I want to thank him and the bipartisan group that he has meet Tuesday mornings. They have been very focused on the long-term issues that confront the country with the budget and the complete unsustainability of our current course. I just want to thank him for all the focus and the effort that he has put into that effort.

Senator Alexander.

Senator ALEXANDER. Thank you, Senator Conrad. I have two questions. One is about the relationship between entitlement reform and health care, and the second is about Medicaid, and excuse my voice a little bit.

The bipartisan breakfasts, to which Senator Conrad referred, has had three straight meetings on entitlement reform and the new Director of the Office of Management and Budget, your former colleague, came today. It was supposed to be a discussion about the President's interest in entitlements and it ended up being almost all about health care reform.

I asked to rejoin the committee so that I could support the Conrad-Gregg effort to find some process by which we could restrain spending on entitlements in the future, and now Senator Gregg has been abducted and I don't know what we will do, but we will find a way to go forward. But one of the initial questions we have got to deal with and the President does and the Congress does, too, is what comes first? There are different views on that.

My instinct is this, that if you are going to try to restrain a system that is growing at a rate as big as the medical system in this country is, taking 18 percent of GDP, that is such a big change that we can't just restrain it. First, we have got to fix it.

And so my question to you is, don't we have to fix, or do whatever we are going to do to Medicare and Medicaid and the health care system before we impose on it the kinds of restraints that will control the growth of its cost?

Mr. ELMENDORF. I think there is certainly a risk that if one simply ratchets down in a mechanical way the spending on health care——

Senator ALEXANDER. For example, if we just tell the doctors who visited Senator Sessions that we are going to cut them to 60 per-

cent for the next 10 years and we are not going to change it every year, I don't see that that is even possible.

Mr. ELMENDORF. So I think that mechanical changes without adapting the system to try to weed out the less useful medical care and keep the more useful care, I think does raise a substantial risk of taking out good, cost-effective medical care. But I think most analysts would also suggest that changes are needed along a whole variety of dimensions in our health care financing and delivery system and that probably the right process is not one thing at a time, but trying a set of things at once and seeing how they work and seeing what can be done better.

Senator ALEXANDER. Well, I think the entitlement issue, though, is more of a process problem than a policy problem. We have got to find a way to force ourselves to deal with restraining growth in such important programs. And because the Speaker doesn't like the Conrad-Gregg idea and the Chairman of the Finance Committee doesn't like it, we are probably going to have to come up with a very gross, blunt method of putting a cap of some kind on the amount of money we can spend on the entitlement programs. It is such a blunt thing that if we do it without making the changes that you just mentioned, we will literally be saying to the doctors in Alabama that it is 60 percent this year and 50 percent next year and we really mean it because we have got a big cap on the way we do things today. That is just my instinct.

Now, here is my second question. In my early years as Governor, in the 1980's, I asked for an appointment with President Reagan and I asked him if he would swap Medicaid for kindergarten through the 12th grade. In other words, I thought the State and local governments ought to be in charge of K through 12 and not expect the Federal Government to do anything. But more importantly, it struck me that Medicaid was grossly inefficient with two bosses and the Federal Government was always coming up, even then, with requirements for who we had to cover without much regard for the difference in the amount of money available in Tennessee as compared to Connecticut.

Medicaid was even in the 1980's beginning to distort State budgets in a way that Washington didn't appreciate. That is even worse today, and without getting into a long thing about it, the real reason college tuitions at State universities are rising so rapidly is because the Medicaid program goes up so rapidly, and Governors, such as the former Governor of Virginia, sit there and have to spend this much on K through 12, and has got a court order about corrections, and has got a certain amount of money for roads, and gets down to the end of it and it is either the University of Virginia or it is the Medicaid program. And if the Federal Government is writing all the rules about the Medicaid program, it ends up being the Medicaid program. So State funding for the university goes down, tuitions go up, and then Congress meets and decides to put a whole bunch of rules on the universities because they don't understand why all that happened.

So what I would like to do is get rid of the Medicaid program. And what I want to ask you is the putting of $90 billion into this recovery package that is coming toward us for the next 2 years for States for Medicaid going to take away from us the option of con-

sidering whether a new system of health care ought to just get rid of the Medicaid program and deliver health care to everyone in a different way.

Mr. ELMENDORF. I think you are right that the joint Federal-State control over Medicaid can be problematic in various ways. I would note one advantage, however, of the State control, which is that there is a variation in Medicaid programs across States and that is a bit of the experimentation process that I have described in which some States have tried to expand coverage in different ways. Massachusetts, for example, under a Medicaid waiver, has pushed a very expansive program for health insurance and that is a situation that analysts are learning a lot from.

And more generally, I think, the underlying question is even if the program were moved to be a strictly Federal program—without changes in the way that it operates, reimburses physicians or who is eligible or something else—the costs are simply being swapped, as you said, and there can be organizational advantages in some cases of a swap, but it is not by itself a solution of the overall spending burden.

Senator ALEXANDER. But State budgets are so relatively small compared even just to the Federal spending on Medicaid. For example, in Tennessee, the State tax dollars collected a year are about $12 billion and the Federal dollars that go to the State are about $14 billion. Just in this new legislation that is the stimulus bill, we are adding $4 billion to the State of Tennessee over 2 years and its annual State taxes are only $12 billion in 1 year. So Tennessee is getting about $2 billion of Medicaid money over 2 years.

I am not arguing about the stimulus bill so much as to say that even if we brought all of the health care spending to a central place, it would be a great act of federalism, in my opinion, because it would strengthen States and allow them to do a better job of other issues and it would help us better organize health care. I agree with you. There is some experimentation that is valuable. But it is a very expensive way to allow for State-by-State experimentation when you compare our TennCare program and the disaster it has been in Tennessee with the Massachusetts program.

Mr. ELMENDORF. If I can just say, I think you are right, Senator, that what you are describing at the State level is what the Federal Government is finding in some ways and what the private sector is finding, which is that the rapid growth of health costs are driving so many other decisions that it has become such an overwhelming part of the activities of the government and the activities of the economy as a whole in a way that seems to be distorting priorities, and I think that is one of the imperatives that many people see for reform.

Chairman CONRAD. I thank the Senator.

Now, we are going to Senator Warner. Let me just say before he proceeds that he comes to us as not only a former Governor of Virginia, but also somebody very successful in the business sector, so he brings a special perspective to these health care issues. And I can tell you, last week the single most interesting hour I spent was in a meeting with Senator Warner, Senator Kerry, and with Larry Summers talking about the fiscal sector. I wish all of our colleagues could have been part of that session, because it was a real

insight into our options and how serious the circumstance is that faces the nation.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and thank you for the opportunity to serve on this very, very important committee and on issues that I have had a chance to wrestle with both at a State level and in the private sector.

I want to focus my comments in two areas, one, around health care IT, and then to followup on Senator Alexander's comments, which I share his concern—a slightly different variation, but clearly share his concern as a former Governor.

I spent 20 years as in the telecom and IT sector and managed to eke out a living. We still wouldn't be where we were in the wireless area if there had not been some level of standards. One of the things that is so frustrating to me about the health care sector, 16 percent of our GDP, is that it remains the only major sector of our society, or our business society, that has not been transformed by information technology. It is still around the edges. And while arguably hospitals and docs and others all have legacy systems, this is not a technology problem we are facing. This is a problem of political will to force upon the health care system some level of standardization.

I saw in some of your study some questions about the efficacy of real cost savings from health care IT. Is that assuming that we are going to continue on this kind of nibbling process as opposed to having some level of across-the-board standards?

Mr. ELMENDORF. I think we are moving toward across-the-board standards, greater interoperability of systems, easier sharing of medical information, with some privacy concerns that people are trying to address, and there is an office in the Department of Health and Human Services that is trying to coordinate our moves as a country.

We think that the right sort of incentives can encourage faster adoption of health IT. I think the principal reason we don't score those as having very large reductions in utilization of health services is the lack of incentives to use the health IT in a way that reduces costs. It is a tool that combined with other—with the right incentives, I think could be more useful than just Senator Whitehouse's example, just having the toaster sitting there.

Senator WARNER. I guess one thing I would urge is that those incentives both include penalties and differential reimbursement levels based upon utilization rates.

Mr. ELMENDORF. Several options do precisely that. They explore different schedules for bonuses for early adoption and penalties for late adoption, and we think those sorts of incentives have an important effect on the rate of health IT adoption.

Senator WARNER. I would just make a comment that we would never have had a wireless system in this country without some governmental entity setting the standards. We would have never seen the transformation of business practices unless there had been, in effect, a Microsoft dominating product.

The sense that the health care area is going to somehow reach some consensus on this—this is not a technology problem. Everybody has got a legacy system. Everybody has got a particular ap-

proach they want to take. I believe, Mr. Chairman, that long-term, we are going to have to weigh-in in a very major way in setting those standards and then be very, very aggressive on both incentives, but also penalties on making sure we move to that. You know, if a doctor doesn't want to change the way he or she practices, that is fine. Well, maybe our reimbursement rate ought to only be 95 cents on the dollar rather than $1.04 if you are going to actually move more quickly to the system.

Following up on Senator Alexander's comments, the area that I want to hone in on, I lived through that exact example on Medicaid costs rising almost faster than any other component, but I can even take a greater step back on a piece of Medicaid, which is the aging of our population. In my State, two-thirds of our Virginia citizens who are in nursing homes are there on Medicaid dollars.

I really question whether we continue to put long-term care and its financing in the health care bucket, and with the aging of our population, whether that is sustainable. Too often, we have never tried to separate out long-term care and how we finance it from a different area. Do you think with an aging population, keeping long-term care in the health care overall approach is sustainable?

Mr. ELMENDORF. I think the deeper question you are noting is how will we as a society pay for long-term care. Right now, in the Nation as a whole, about half of long-term care costs are paid by Medicaid, some by Medicare, some by private long-term care insurance or out-of-pocket. I have two parents who spent time in long-term care. The costs are overwhelming and I don't think we have a plan.

Senator WARNER. I would argue that there needs to be some societal understanding that there is an individual responsibility to start planning for some level of long-term care when you turn 21 or turn 25. It is not going to be simply a government obligation long-term. I don't see how it is sustainable.

And a followup on that, and I know we had an individual conversation about this and I hesitate to raise this kind of issue in this kind of setting, but this is not just a governmental responsibility, it is a morality responsibility, it is a faith responsibility, but at some point in this dialog around health care, somebody is going to have to start a discussion about end-of-life issues. We constantly hear—I have heard estimations as Governor that ranged from 30 percent to 60 percent, based upon the last 3 months to last year of life, and how we sort through those issues in an appropriately compassionate way but recognizing we oftentimes put the decision on the family and the doctor at that most critical time when there is not really a qualitative assessment, there are not really any kind of norms and standards that we have set up.

This goes beyond the realm of governmental action, but at some point, in my mind, at least, it needs to be part of the discussion. Have you done any analysis of what those end-of-life costs amount to in terms of our overall health care spending and the expected rise in those costs, as modern medicine continues to find new techniques and advances to keep folks alive longer?

Mr. ELMENDORF. You are certainly right, Senator, that a large share of Medicare spending goes to people near the ends of their lives. I don't think CBO has done any particular further analysis

on that topic, although I might—I mean, you have got it there and I might be mistaken and we will get back to you if we have, but——

Senator WARNER. I would love to see that, because I have seen estimates all across the board about how big a chunk of our health growth—

Mr. ELMENDORF. There is no doubt it is a tremendous amount of money. It is complicated by the fact that it is not always obvious it is the last of life until it is the case. But also, I think you are just right that we don't know how to make decisions very well about what sorts of care are appropriate and what sorts of care are not. And in some levels, you say that is ultimately a moral question, which is beyond my official capacity.

Senator WARNER. I understand. Thank you. Thank you, Mr. Chairman.

Mr. ELMENDORF. Thank you, Senator.

Chairman CONRAD. Thank you, Senator Warner.

Now we have Senator Stabenow, who has also been very dedicated on this committee to health care issues and is a key reason we held this committee hearing this morning. Senator Stabenow, welcome.

Senator STABENOW. Thank you, Mr. Chairman, as always, for your leadership on this issue and so many others. I would just add my voice on health information technology for a moment.

I think Senator Warner was raising important issues as to carrots and sticks in the process. I would just remind us that in the Medicare bill we passed last year we did put in E-prescribing incentives for the first time that does have in fact a carrot at the beginning, and a stick at the end of 5 years. It did score as a savings for us as a start.

We have in Southeastern Michigan a partnership with the automakers, United Auto Workers, Blue Cross and Blue Shield, which has now signed up 25 physicians doing E-prescribing, and it has not only addressed savings—and I would urge you to look at that, Dr. Elmendorf, if you have not already.

But they have found from a quality standpoint that when they are using a system where they can look at allergic reactions to drugs, counter-indications, duplications and other things, that they are actually changing the prescription about 30 percent of the time to more accurately reflect what should be done, so that there are huge quality issues that relate to our ability to have information and be operating in that way.

There are, Mr. Chairman, some very exciting things happening in Michigan. We have some very exciting efforts going on locally through healthcare systems and so on that I hope, through the economic recovery plan and the dollars we're putting in, we can begin to connect all of that.

But the providers, many of them are way ahead of us. They're out there doing what needs to be done. I would urge you to really look at what is being done in many places.

I wanted to speak—I know there's been a lot of discussion this morning on the Medicare and Medicaid costs and in the last Congress I remember then GAO comptroller, General David Walker, noting that Medicare and Medicaid spending threatens to consume

an untenable share of the budget and the economy in coming decades.

But I also remember at the time that he went on to say that healthcare spending system wide continues to grow at an unsustainable pace, eroding the ability of employers to provide coverage to their workers and undercutting their ability to compete internationally.

In other words, the challenge facing us is beyond the Federal Government. One of the things that I see is that when the private sector cuts on healthcare then it moves over to the public sector in some way, maybe children's health insurance or Medicaid, or it may be something else. When the government cuts, it moves someplace else.

And so I guess my question and comments would be around the need for system wide health care reform so that we are not focusing on Medicare and then seeing the costs pop up someplace else. I wonder if you might speak a little bit more about that and the fact that it is important that we not shift the costs around from public to private sector?

Mr. ELMENDORF. I think most analysts would agree with you absolutely about the need for system wide reform. The Federal programs, Medicare, Medicaid, CHIP, are important; however, we should not forget their importance. They are a large share of spending to start with.

Senator STABENOW. Right.

Mr. ELMENDORF. And also, they can set examples for other parts of the healthcare system. Providers who invest in health IT because Medicare makes them, will presumably use that health IT for all of their patients, and the effect of that on healthcare utilization is as part of CBO's estimate of the effects of health IT investment in Medicare because of those spillovers.

Also I think that if Medicare can demonstrate the benefit of medical homes or accountable care organizations or other ways of restructuring care so people have an incentive to coordinate the care and to provide it cost effectively, those examples will then reverberate through the private system as well.

As far as the private system itself, as Senator Whitehouse pointed out, the Federal Government does not directly control how healthcare is delivered throughout the country. But there are some levers the government does have right now. One, which we have discussed, is the tax exclusion for health expenses paid by employers.

I think many analysts would agree that that exclusion could be restructured in a way that would make individuals more sensitive to the costs of the healthcare that can now be somewhat masked by the fact that the employer pays it and you never really see it.

It turns up in lower wages for people and that is an important factor in the slow growth of wages, but it is not so visible. There are ways to change the health exclusion that would bring the cost to bear more directly on individuals and on their employers in a way that could propel the private sector to be more aggressive in modifying the way healthcare is delivered.

So there are some levers that you do have.

Senator STABENOW. When you talk about restructuring, what would be the kinds of things that you would suggest that we look at, when we talk about the tax treatment?

Mr. ELMENDORF. Right now, as I had mentioned earlier, the government loses about $250 billion a year through the income and payroll tax exclusion of health insurance expenses by employers. If we were to take away some of the benefit that I, for example, derive from that, and use that to provide more incentive for people in the lower tax brackets to get care, to buy insurance rather, I am unlikely to drop insurance and somebody in the lower income bracket is more likely to pick up insurance.

So shifting some of the tax benefit from higher income people who work largely for firms that provide insurance in a subsidized way—toward people at lower income levels for whom health insurance is a larger burden, or who are more likely to work for employers that do not provide insurance now—that shift would likely raise insurance levels.

Now to be fair, it raises my taxes, so it is not an approach that everybody will stand up and cheer for. But that is a sort of restructuring that gets more people into health insurance. Beyond that, if one reduces the amount right now—however much—when I worked for the Federal Government—but when I was in the private sector—however much they paid for my health insurance, all of that was deductible or excludable from my compensation so it was not taxed.

If instead we capped the amount that could be excluded, then that would still provide an important subsidy for a more basic health insurance, but any additional health insurance, more expensive policies, that extra money would come out of somebody's after-tax income. That would make them very sensitive to whether that extra more expensive policy was worth the extra amount relative to what else they could have bought with that money.

So that kind of cap is a way of ensuring that people see the cost of buying more expensive insurance and see an estimation that would actually have a significant—that kind of cap would have a significant effect on how much a health insurance premium is worth down the road.

Senator STABENOW. Thank you very much, and thank you, Mr. Chairman.

I would hope that as we talk about Medicare and Medicaid that we will talk about it also in the larger context of healthcare reform since it is all connected. Having come from a state with a lot of employers providing health insurance, we see very directly what happens when they drop insurance or when they add insurance and how it moves from the public to the private sector. So I look forward to working with you as we look at this in totality.

Chairman CONRAD. Thank you very much, Senator Stabenow. I would like Dr. Elmendorf in the remaining minutes of the hearing—we have a series of votes at noon—I also should advise members and their staffs that tomorrow we will have the Secretary of Treasury, Mr. Geithner, here to talk about the financial sector and to talk about housing. So it is a critically important hearing the day after he announces his plan.

With respect to healthcare, from a budget perspective, which of the options that you have analyzed with your colleagues at CBO show the greatest potential for bending the cost curve long term? So what I'm trying to get at is, what are the changes in policy that give us the biggest bang for the buck in terms of reducing healthcare costs while maintaining or improving healthcare quality?

Mr. ELMENDORF. So I have not done that comparison explicitly, Senator, but this is the right question and I will go through the book more carefully in search of the answer.

I think in general though, I would caution against picking out just one or two items. I think as I have said in the answer to a number of questions, there is great uncertainty surrounding every one of these numbers that CBO has written down. We put down a number because we think you need that, but it's really a range of course, and a pretty broad range.

There is a whole collection of these proposals that would restructure care in a way that might work, but might not, so we do not really know whether accountable care organizations are a better or worse idea than medical homes, so we have taken some stab at that, but we do not know for sure.

I think the things that broadly speaking——

Chairman CONRAD. Can I just say to interrupt for a moment and say to you look, what we have got to have, we have got to have a prioritization of things that have the greatest prospect of working.

I will tell you, I have been in a lot of discussions over the last several weeks publicly and privately about where this is all headed. The sweet bye and bye is upon us. Our colleagues who do not yet fully appreciate how acute the situation is and how urgent the need is to change course, are, I think, in for very rude surprises in the weeks ahead.

We have got to be prepared to make changes. This course we are on cannot be sustained. I have had some of the most learned people in this country call me, some of them so concerned they have called me at home and said to me, don't people understand that we are headed for a collapse of this currency, not now, not next week, not next year, but off in the future if we do not deal with these long-term trends?

I have had some of the most prominent economists. We have had them testify here. We had Allen Sinai sit at that desk and tell us we are headed for a country that will look like a Banana Republic if we do not deal with this long-term funding issue. And of course, health care is the 800-pound gorilla.

If we look across the areas of concern, the place that just jumps out at you is health care. So we very much need you and your colleagues' best judgments as to what are the individual items and the collection of policies that have the greatest prospect of bending the cost curve.

If I were to ask it that way, what would you say? Based on what you know now, and again, we know this is not a slam dunk. This is not an area where there is certainty. If there was certainty, we would have acted. But what do you see as the places where policy could be altered that would give us the best shot?

Mr. ELMENDORF. I think the cleanest and strongest lever that you have about private health care is the tax exclusion. As I said in my testimony, I think many analysts would agree that adjusting that exclusion can be very beneficial for health insurance coverage and for ensuring a more efficient health care system.

In the public sector, you have, I think again, a comparably clean and strong lever would be increasing cost sharing by Medicare beneficiaries and we score some examples of that policy, those sorts of changes, a number of different ways in which there could be larger co-payments.

We score a number of those in our document. But to be clear, the savings of the Federal Government are partly reduction in utilization, but more importantly, shifting of the costs to the beneficiaries. So it is not all—sometimes the Federal savings exceed the savings for the country. This is an example of the case where the government is saving a lot, but some of that is being shifted back to beneficiaries.

So it saves Federal health costs but with consequences. I think the more subtle things, and this is where I am not sure what I would put higher or lower on the list, are the specific sorts of ways in which Medicare could reimburse physicians and hospitals more for value provided than for the number of services provided. That is a set of options.

Chairman CONRAD. Let's stop on that point and explore that a little more fully, because I have come to the conclusion—this is critically important—that is that right now the reimbursement system is based on procedures and guess what, if you reimburse on procedures, you get a lot of procedures. Whether or not they are particularly efficacious or not, if you reimburse based on the number of procedures, you are going to get a lot of procedures.

So what could be done to change the incentives with respect to that part of the system?

Mr. ELMENDORF. We cite a study in my written testimony that says cases where doctors are paid salaries—rather than being compensated as some share of the services that they induce—that use of medical care is 30 percent less because they do not—apparently because they do not have this incentive to do more.

Chairman CONRAD. Thirty percent less? Thirty percent fewer procedures or 30 percent less cost?

Mr. ELMENDORF. Thirty percent less spending on health care I think is the fact. In an example where patients were assigned randomly either to a traditional fee-for-service setting or to a case where doctors were paid some salary that does not depend on the number of services.

For doctors though who now practice independently, trying to figure out how to do reimbursement that way is difficult. One could force them all into managed care organizations of some sort, but I don't think that is really in the feasible set for you.

So instead what happens is—people have experimented with this to some extent—are inducements to doctors to band together, so we talk of in this book about what we call bonus eligible organizations. That is a set of doctors who if they can maintain quality and reduce spending over a period of a couple years, get some share of

that reduction in spending and the government gets some share of the reduction in spending.

Chairman CONRAD. I like that idea very much. I come from a long line of doctors in my family. My grandfather was a surgeon and the medical chief of staff of our local hospital. I have great respect for doctors, medical professionals and I have seen the incredible dedication that many bring to their jobs.

So I think we have got to have a carrot approach here to make it attractive for them so they are in on the solution and they feel that they are being treated fairly. I am very intrigued by that notion of creating an incentive for them to participate in that kind of health care organization. What else——

Senator STABENOW. Mr. Chairman, might I interject just on that one point?

Chairman CONRAD. Yes, absolutely.

Senator STABENOW. There is a really excellent partnership between Johns Hopkins and the Michigan Hospital Association called Keystone Initiative, which I think I have mentioned before, that goes to this kind of approach of working with doctors on an evidence-based standard system to look at outcomes. They started out with an intensive care unit and they looked at very simple things they could do to stop the transfer of infections, and very simple things, washing hands, doing things that—but doing it in a very standardized way.

Chairman CONRAD. A checklist.

Senator STABENOW. And measuring people. A checklist, exactly. They do the checklist and they have found that they have saved over a course of a few years now, about 1,500 lives and $165 million in health care costs by just stopping the infections that happen within the hospital setting.

If we could institute more of an incentive base for those kinds of things where—because they are now also expanding. They are working with HHS to look at pilots around the country and there are other pieces they are looking at.

But some of these are very simple really and straightforward, but they take some structure and some time and attention and I think if we were incentivizing and rewarding this, it could be an important part of increasing quality and decreasing costs.

Chairman CONRAD. You have mentioned to me this Keystone Initiative before and talked about the savings and improved health care outcomes. One of the things that jumps out at me in the data is Mayo Clinic and the hospitals associated with Mayo. My relative who is a nun used to be the administrator of the hospital at Mayo, the lead hospital there, and she was for many years the administrator. They get outstanding outcomes at a fraction of the costs of some of the other major medical centers.

It really is very dramatic. Better outcomes, less cost. Have you analyzed that differential?

Mr. ELMENDORF. A leading health economist said to me this past week that we have proof of concept about effective hospitals and effective medical practices. There are cases, and the Mayo Clinic is a very important example, where care is delivered very—more effectively than most places and at less cost than most places.

It is trying to spread that around, those examples around the country, that is important. So one incentive regarding hospitals that we talked about in this book would be when hospitals have readmissions of patients that they have treated and released but they have come back—some of those happen just because of the nature of the illness and some happen because hospitals have not done the right sorts of things in the hospital or the right things in terms of post-acute care.

We can penalize hospitals. We could not reimburse them fully for the re-admitted stay and that sort of penalty would certainly induce them to be more careful about things. The way that we had mentioned is we could bundle the payment for the stay in the hospital and the care after the hospital, bundling those together with one payment rather than what we now do, which is pay for the in-hospital care but then pay extra for as much other care as you get.

Chairman CONRAD. That would be a huge incentive wouldn't it?

Mr. ELMENDORF. Right, and those are the things that we talk about in this book that save money in our estimation.

Chairman CONRAD. How do we encourage institutions to move toward a model like what we see at Mayo? There they have an integrated care system, right? You've got the clinics, the hospitals. You've got, as I understand it, a partnership that involves the doctors and you have a team approach to patient treatment and an integrated approach.

What are the other things that we can learn from the Mayo approach?

Mr. ELMENDORF. I think the integration point is important. We have a tradition in this country in many places of medical care being practiced by solo practitioners, individuals, and that may have made sense at the time of a more rural country with much simpler medical technology and treatments.

It seems to make much less sense to most analysts given our current concentration in many parts of the country and the complexity of medical treatments that can be administered, and I think we are in the process of a shift toward less solo work in medicine and more of these teams that you describe.

It is a very strong cultural shift in many parts of the country. Some parts of the country have come naturally to that without being forced or induced by particular incentives. Economists usually answer, if you are trying to change other behavior is that sermonizing is OK, but financial incentives are very powerful. I think people, in our estimate, suggest that—we think people can be moved to explore new things they might in fact like, but maybe need some incentive to get going in that direction.

I think incentives can be very effective over time.

Chairman CONRAD. Senator Stabenow, do you have additional——

Senator STABENOW. Just on that point, Mr. Chairman, it made me think of a conversation I had with a very smart, creative hospital administrator who came from outside of health care to be involved in managing a hospital system in Michigan who told me the other day that he thought that payment incentives were the way to move the system, that when he looked at what caused change

to happen or what he was able to do with change, that that was the way that we move the system.

So when we provide a payment incentive for E-prescribing, people move to E-prescribing. If we were to provide—I also think that to get to the comparative analysis on quality that we need, that health IT is an integral part of that because I do not know how you get the information if you do not do that.

But I do think that there is something to be said for structuring incentives in the direction we want to go and then my guess is the system will move there.

Chairman CONRAD. Well, I believe it.

Mr. ELMENDORF. I do too.

Chairman CONRAD. OK, now we got three. We are on a roll. You know, the clock is really ticking. You look at these numbers; they are so striking. Eighty-three hundred dollars per capita health care costs, $8,300.

Mr. ELMENDORF. It is stunning.

Chairman CONRAD. That is why—and I want to end this hearing as I began it. I want to send a message to those who believe the answer is putting a lot more money into this system that they got a very heavy burden to bear.

I understand maybe to change the system is going to require some front-end costs, OK; I can accept that. But the notion that we are going to go from 16 percent of GDP to 18 to 20 percent of GDP, we are on a track now by 2015 we are going to be at 20 percent of GDP, one in every $5 in this economy for health care. That will be double any other industrialized country in the world, on the current trend lines, double.

Now we are not—if we are getting by far the best results, that would be one thing. But we are not. We are not even close. I do not think on the last analysis we are in the top 20 in health care outcomes.

So being twice as expensive and not getting the very highest quality tells you we got a system failure and it is of enormous proportion and it makes our country less competitive. It makes our people less affluent and to the extent we have a health care system that does not deliver quality outcomes, it makes our people less healthy than they would otherwise be.

My goodness, we have got to be able to do better than this and we very much need your help and the help of your associates to point the way in terms of what we try to do. And we have got to be very humble about this because the truth is, there is not certainty about changes that could be made here that would make a difference.

So let's be humble about it, but let's not let humility prevent us from acting, because the course we are on is completely and utterly unsustainable. So that is our challenge. Thank you very much.

Mr. ELMENDORF. Thank you, Mr. Chairman.

Chairman CONRAD. We will conclude the hearing.

[Whereupon, at 11:55 a.m., the committee was adjourned.]

POLICIES TO ADDRESS THE CRISES IN FINANCIAL AND HOUSING MARKETS

WEDNESDAY, FEBRUARY 11, 2009

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

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

Present: Senators Conrad, Murray, Wyden, Nelson, Stabenow, Menendez, Cardin, Sanders, Whitehouse, Warner, Sessions, Enzi, Bunning, Crapo, Ensign, Graham, and Alexander.

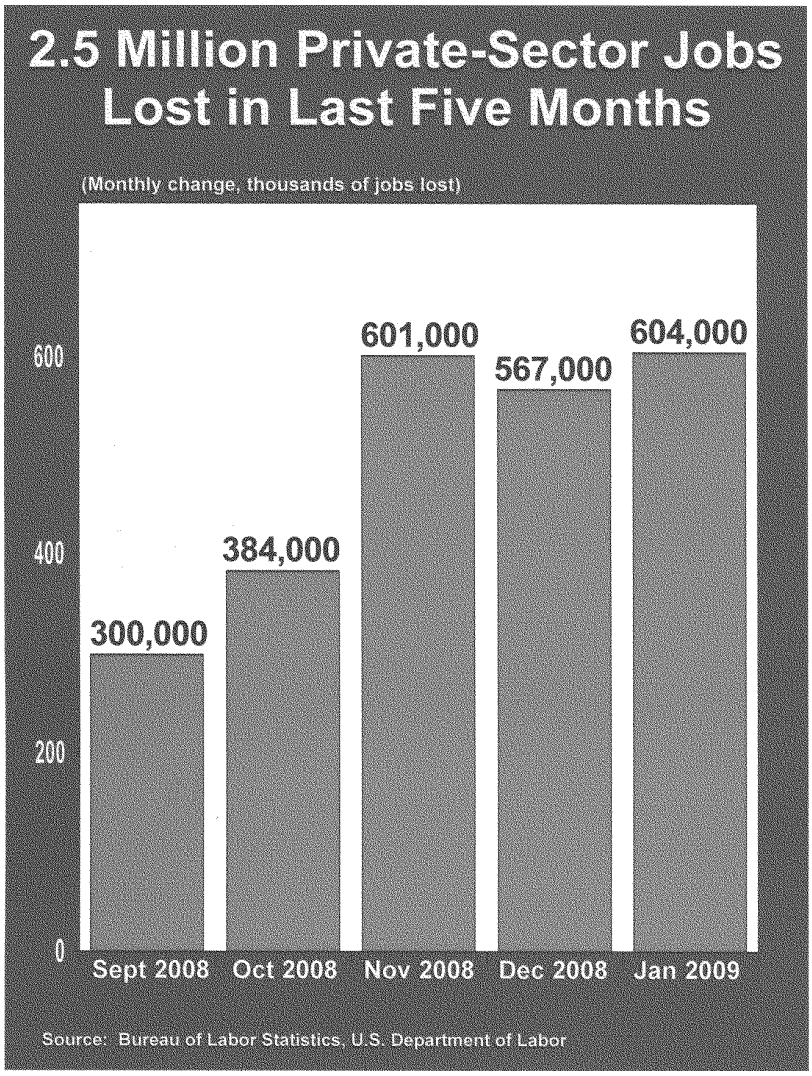
Staff present: Mary Ann Naylor, Majority Staff Director; and Denzel McGuire, Minority Staff Director.

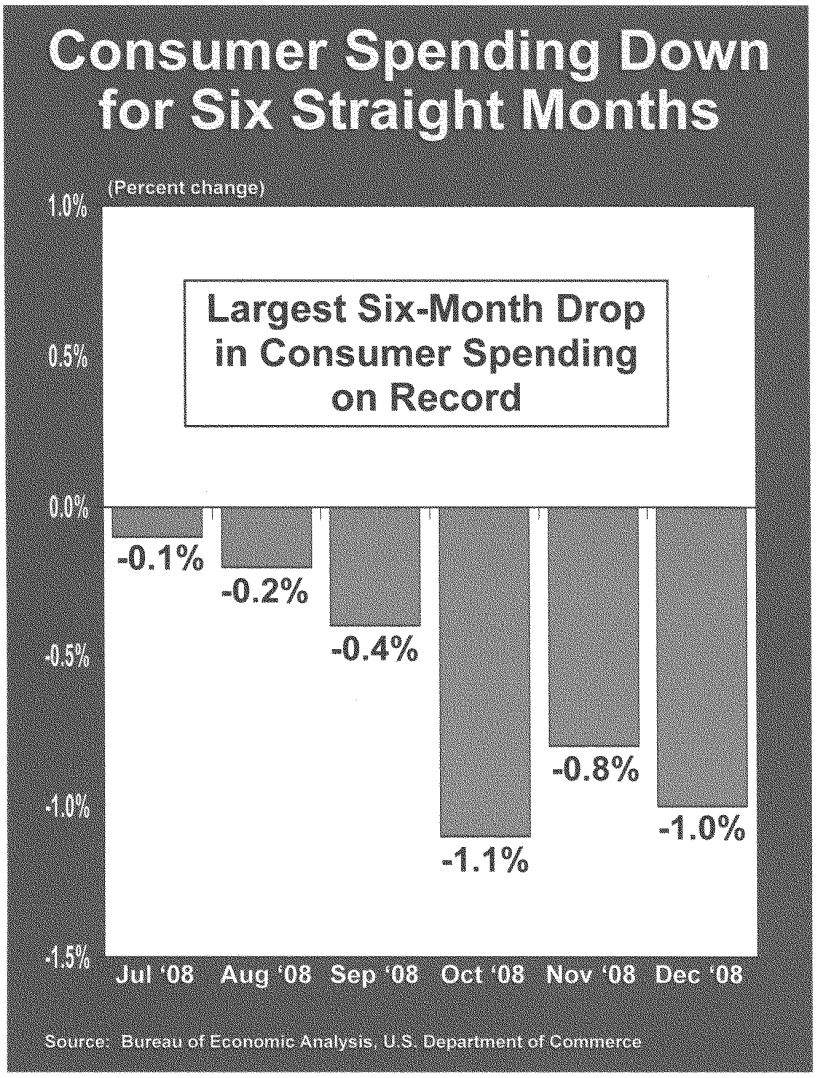
OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to welcome everyone to the Senate Budget Committee today. Our witness today is the Secretary of the Treasury, Tim Geithner. We want to welcome Secretary Geithner to the Budget Committee in his first appearance here of what we anticipate will be many appearances, because we have obviously a need for a close working relationship with the Secretary of the Treasury. It is traditional that the Secretary come before the Budget Committee to talk about the outlook, and obviously, we are not the Budget Committee—or the Banking Committee. We are the Budget Committee. And so I will try to confine my inquiry to the things that really matter to this Committee, the Budget Committee. But we all recognize members are free here to ask whatever questions they deem appropriate. That is their judgment to make. But, again, I am going to try to pursue what the implications are for our overall budget circumstance because that is our first obligation.

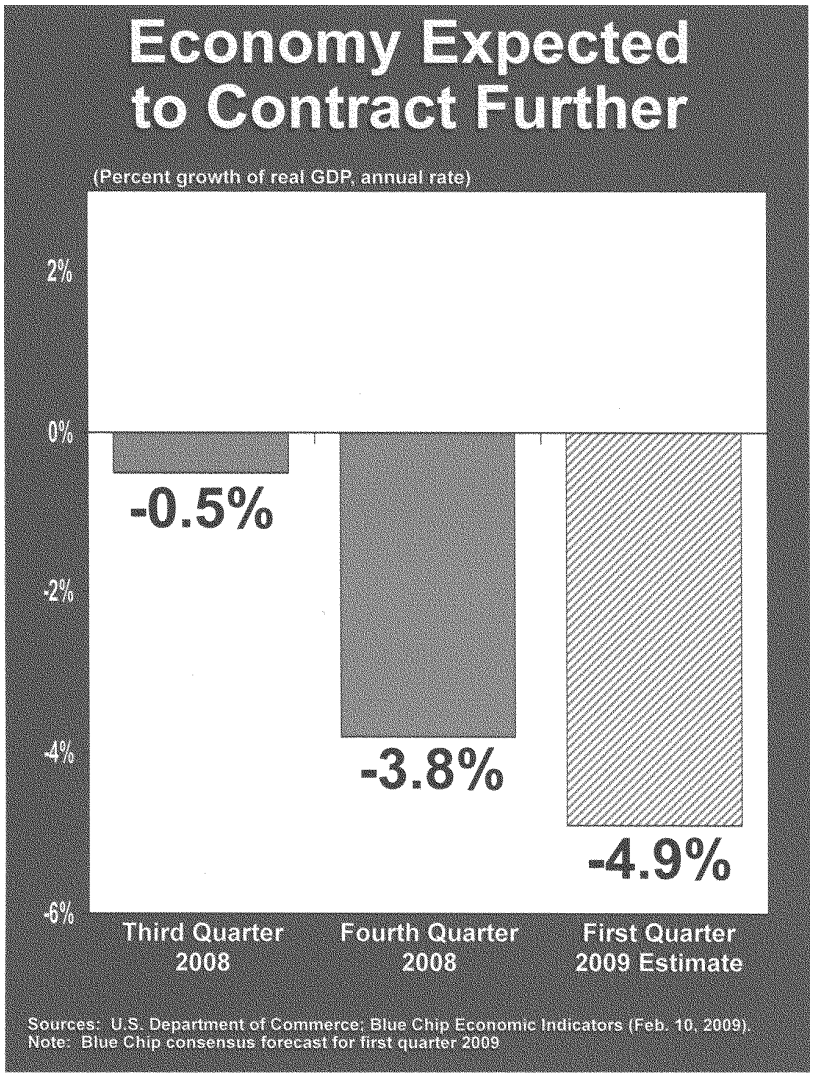
With that, I think we all know that we are in an extremely serious economic situation: 2.5 million private sector jobs lost in the last 5 months; consumer spending down for 6 straight months. We have the largest 6-month drop in consumer spending on record. And it is interesting, reading press commentary of today and yesterday, this paradox between wanting people to save more—you know, many of us have talked about the need to save more for many years. On the other hand, in this circumstance, when consumers save more, that means they are spending less. That means aggregate demand is further reduced, and, of course, in economic terms, one of the problems that we face is a drop, a rather sharp drop in aggregate demand.


2.5 Million Private-Sector Jobs Lost in Last Five Months
(Monthly change, thousands of jobs lost)
600
400
200
0
300,000
384,000
601,000
567,000
604,000
Sept 2008
Oct 2008
Nov 2008
Dec 2008
Jan 2009
Source: Bureau of Labor Statistics, U.S. Department of Labor

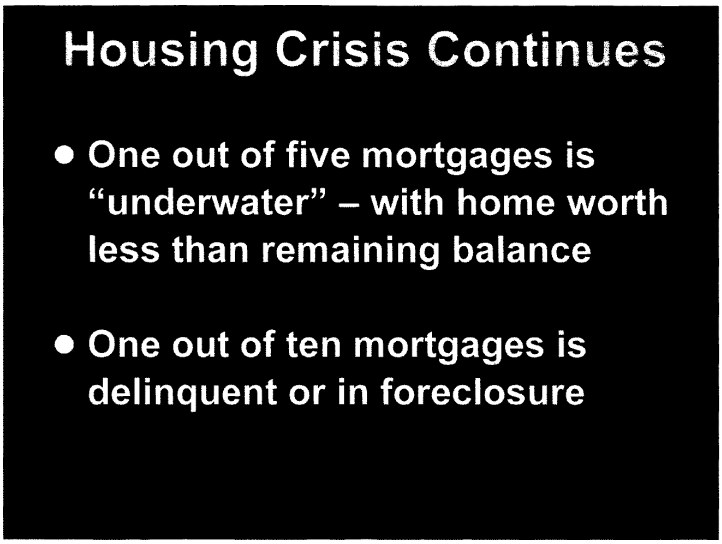


So in the short term, we know that has to be addressed to prevent further economic damage, while at the same time we recognize over the longer term we do need to encourage more savings so that we can have pools of capital available for investment, so that we can have long-term economic growth. That is the paradox of the moment, and as is so often the case, what works in economic terms is counterintuitive.

We also anticipate that this economy is going to contract further. In the fourth quarter of 2008, the economy contracted by almost 4 percent. The first quarter estimate for 2009 is a contraction of nearly 5 percent.

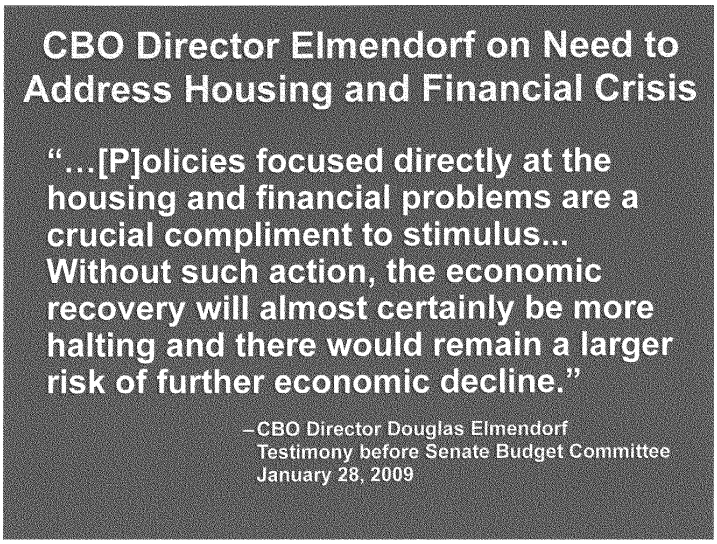


And in the midst of all this, the housing crisis continues unabated. One out of five mortgages is underwater, with homes worth less than the remaining balance; in other words, people are upside down.



They owe more money on the mortgage than the house is worth. We have had testimony before this Committee that one out of every four houses in the country is upside down. I am not certain which is the right measurement, whether it is one in four or one in five. Either one is a cause for real concern. And, of course, one in every ten mortgages in the country is delinquent or in foreclosure.

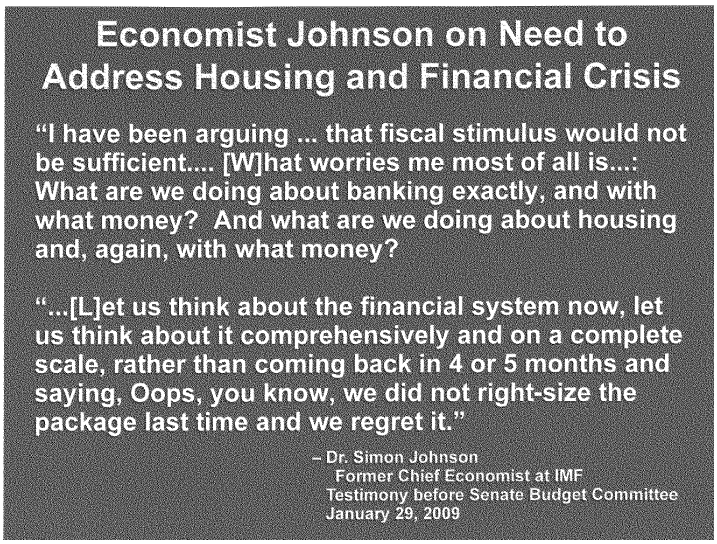
The CBO Director came before us—Dr. Elmendorf—and talked about the need to address both the housing crisis and the financial crisis. Here is what he said: "Policies focused directly at the housing and financial problems are a crucial complement to stimulus. Without such action, the end recovery will almost certainly be more halting and there would remain a larger risk of further economic decline."



That is a message I have tried to deliver repeatedly and consistently over the last several weeks, that while we are doing an economic recovery package—which is absolutely necessary. We can debate its contents and its mix and whether it is as good as it could be. That is a separate subject. But I do not believe and I do not think most economists believe we are going to have the kind of economic recovery we all want unless we deal with the housing crisis and the crisis in the financial sector as well.

We had testimony last week before this Committee, really riveting testimony, by three prominent economists, including Dr. Simon Johnson, the former Chief Economist at the International Monetary Fund, who said this on January 29th: "I have been arguing that fiscal stimulus would not be sufficient. What worries me most of all is: What are we doing about banking exactly, and with what money? And what are we doing about housing and, again, with what money?"

Let us think about the financial system now. Let us think about it comprehensively and on a complete scale rather than coming back in 4 or 5 months and saying, "Oops, you know, we did not right-size the package last time and we regret it."



Mr. Secretary, that is really going to be the thrust of the questions that I have. What is it that we need to do to specifically address housing? What is it that we specifically need to do to address the financial sector? And what money are we going to use to do that? That is distinctly in the province of this Committee. That is our fundamental responsibility to our colleagues.

I hope, to the degree that we can, we focus on those issues but, again, I want to make clear colleagues have the right in this Committee to ask questions of our witnesses on any subject they deem appropriate.

With that, I will turn to Senator Sessions, who is here filling in for Senator Gregg, who we all know is going through the confirmation process. And if he is successful there, Senator Sessions will be the Ranking Member on this Committee. I welcomed him to that post yesterday, and I welcome him again today. Senator Sessions.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Mr. Chairman, and we do appreciate the leadership Senator Gregg has given to this Committee and that you have. In fact, you have had a great partnership, and it has been valuable to the country, and I hope, if my colleagues allow me, to participate in a positive way as well.

Secretary Geithner, thank you for appearing before the Committee today. We want you to succeed. There are a lot of challenges out there. Over the last 6 months, the American people have watched with increasing concern as our economy has further stumbled and faltered. This is a confusion and anxious time for Americans. I travel my State a lot and talk to people. While the economic challenges are complex and the root causes of those challenges provide a lot of fodder for academic debate, I think the American people are far more focused on finding a responsible solution that will restore certainty to the market—uncertainty is not good—and growth to the economy.

So those are my thoughts, basically, and I want to again reiterate that while I have opposed some of the solutions that have been promoted under President Bush and that appear to be continued, we are heading down a road that we want to be successful at, even if it may not have been my personal choice.

This much is very clear: The average homeowner knows his property has lost value, but the Government has done little to explain why to the average American—perhaps it is understood within the Beltway, but not outside the Beltway. Experts cannot justify effectively to a middle-class worker why his job no longer exists, and analysts are hard pressed to demonstrate in clear and simple terms why it is more difficult for a small business owner with good credit to get a loan than it was before.

To a large degree, I think—and I would make this criticism—our national leaders are promoting fear rather than more confidence that we will work our way through this eventually no matter how tough the challenges are, and that fear can actually sometimes make things worse.

People do understand that markets are cyclical, that they go up and down. Most Americans are willing to accept the reality of tough times, adjust to the circumstances, and to persevere. But even so, they have looked to the Government for an explanation of what has happened and for leadership as we right the economic ship.

The only thing murkier than the root causes of the economic problems we face, I think, is a muddled response from our Government.

To my amazement, the Bush administration urged Congress to act so quickly last fall, at one point setting the opening of the Asian markets as a deadline that we had to pass the legislation by. Of course, that passed, and we eventually passed pretty much what they asked for, but not when they said it was so critical.

So rather than closely study the challenges, understand their root causes, and formulate a targeted response, Congress basically washed its hands of the problem and gave the authority to the Secretary of Treasury, and along with $700 billion. Secretary Paulson requested and received maximum flexibility to allocate the money however he saw fit, with little oversight. A week after he testified that the massive funds would be used to purchase toxic assets from banks—and in his testimony he specifically rejected buying stocks—he shifted gear to buy ownership stack in the Nation's financial institutions. I am confident that had the Secretary announced that he intended to buy equity stakes in banks, it would have received a good bit more hostile congressional response.

Four months removed from the vote on that TARP plan, I believe most in Congress have heard from their constituents that they were not happy with it. The program, which was engineered with assistance from you—you were one of Mr. Paulson's advisers in that process—has not received good marks so far. Rarely has there been a Government program so large, so expensive, and so important that has met with so much public resistance and expense.

In the real world, borrowers must present an application for a loan, demonstrate their ability to repay it, and sign a promissory note promising to pay back their debts. In a bankruptcy court, the

petitioner must stand under oath and recount his debts and his assets. Even in the days of the RTC hearings, public transcripts were made, testimony was made available to the public. In the Paulson-Geithner world, decisions allocating huge sums of money, picking some private companies as winners and others as losers, seem to be made behind closed doors. There are no public hearings, no transcripts that I know of, and little justification for how those decisions are made. The procedures used are the procedures chosen by the Secretary of Treasury, and those procedures can be altered at his whim.

This goes against the American heritage of law, individual responsibility, congressional oversight and accountability, limited Government, and free enterprise. Those principles are important, and each one of them is eroded by this process. The Obama administration has made it clear that a dramatic reformulation of this program is needed before the second tranche of the $350 billion is allocated. The market has made clear that certainty and stability are commodities of great demand, and I think many of us were looking forward to a plan that could be presented in a straightforward, clear, and detailed way. Unfortunately, that is not what we received yesterday. At least that is not what the markets and the country perceived they heard.

The country's financial sector needs a better understanding of how the Treasury intends to move forward with this economic recovery. Congress as the people's representative must evaluate that plan, I think, and either approve it or disapprove it. So we look to you, Secretary Geithner, to lay out a detailed plan in clear terms about how you suggest we should proceed. I think the reviews of your performance from yesterday are in and they are not good. You were involved in this process from the beginning and you have had more than a month to work on the proposal. But what we have heard is more of an outline, short. . . on details about how we are going to fix this financial system, which is the core, I agree, Mr. Chairman, of the problems we face.

So I hope you can use the hearing today to put some meat on the bones—as I heard a British analyst say on the Business Channel this morning, it needed more meat on the bones of your proposal, and I hope that we can work together and make some progress for our country. I believe this Nation will bounce back. If we use smart policies, we can help it be faster and less painful.

Thank you.

Chairman CONRAD. Thank you, Senator Sessions.

Again, Mr. Secretary, welcome to the Budget Committee, and please proceed with your testimony.

STATEMENT OF HONORABLE TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Thank you, Chairman Conrad, Senator Sessions, and members of the Committee. Thanks for inviting me here today. It is a great privilege for me to appear before you today as my first time as Secretary of the Treasury, and I look forward to doing it many more times. I believe deeply in the importance of a close working relationship between the Treasury Department and

this Committee and your colleagues on both sides of the aisle, and I will work very hard to achieve that.

I have laid out a somewhat longer prepared statement today, but I want to depart slightly from my text, and I want to go through and emphasize a few important elements of how we got here, the broad principles that guide our approach, and I will give you this framework of programs that we think are necessary to solve this crisis. But this is the beginning of a process of consultation, and I completely understand the desire for details and commitments. But we are going to do this carefully, consult carefully, so we do not put ourselves in the position again where we are laying out details ahead of the care and substance necessary to get it right, which requires quick departures and changes in strategy. I do not want to do that. I do not think that would be helpful for certainty. And I want to be careful and be responsive to the understandable desire in the Congress and elsewhere that we consult as we design and go forward and that we be careful to get it right.

Now, I want to begin a little bit by how we got here. The causes of this crisis, enormously complicated, took a long time to buildup, and they will take a long time to resolve. Governments and central banks around the world—and now I say this with the benefit of hindsight, but governments and central banks around the world pursued policies that contributed to a huge global boom in credit. Investors and banks took risks they did not understand. Individuals, businesses, and governments borrowed beyond their means, and the rewards that went to financial executives departed from any realistic appreciation of risk.

There were systemic failures in the checks and balances in our system—by boards of directors, by credit rating agencies, and by Government regulators. And these failures, not just here in this country but around the world, have helped lay the foundation for the worst economic crisis in generations. And when the crisis began, governments around the world were too slow to act. When action came, it was too often late and inadequate. Policy was behind the curve, always chasing the escalating crisis. The dramatic failure of some of the world's largest financial institutions caused investors to pull back from taking risk.

Now, last fall, as the global crisis intensified, you and your colleagues acted quickly and courageously to provide emergency authority to contain the damage—authority that your Government did not have until you acted. And your Government used that authority to help pull the financial system back from the edge of catastrophic failure.

Now, those actions were absolutely essential, but they were inadequate. The force of the Government response was not comprehensive or quick enough to withstand the deepening pressure brought on by a weakening economy. The spectacle of large amounts of taxpayer assistance going to institutions that were at the heart of the crisis with limited transparency and oversight added to a deep sense of public distrust, and that public distrust turned to anger across the country as boards of directors at some institutions—not all, but at some institutions—continued to award rich compensation packages and lavish perks to their senior executives.

And our challenge and your challenge today is much greater because people have lost faith in the quality of judgments of the leaders of many of our major financial institutions, and they are skeptical that the Government to this point has used taxpayers wisely in ways that will benefit them.

Now, my judgment is to get credit flowing again and to restore confidence in our markets to restore the faith of the American people, we are going to have to fundamentally reshape the Government's program to repair the financial system. And I want to be candid. This is going to cost substantial resources, it is going to involve risk to the Government, and it is going to take some time. But as costly as this response will be, I am also confident that a failure to act, a failure to act with force and speed, would be much more costly to the families and businesses across the country.

If we are not acting with candor and honesty about the scale and difficulty of this problem today, ultimately it will cause more damage to the productive capacity of this economy, more damage to our capacity to fund the things the Government needs to do in the future, and more damage to families and businesses across the country.

Now, we are going to have to adapt our program as conditions change. We are going to have to try things that have not been tried before. We are going to make mistakes as we go forward. And we are going to go through a period where things get worse and progress will be interrupted.

This is a challenge more complicated and more complex than any that our system has faced, and it is going to require new programs and a sustained effort to solve it, and we are going to have to work together to do it.

Now, our work is going to have to be guided by not just the lessons of the last 18 months, but by the lessons and the failures of financial crises over the course of history. And I just want to state quickly the basic principles and values based on those lessons that have to shape our strategy.

We believe the policy response has to be comprehensive and forceful and that there is more risk and greater cost in being gradualist and tentative than there is in aggressive action. We believe that the action has to be sustained until recovery is firmly established. In this country in the 1930's, in Japan in the 1990's, and in other cases around the world, governments applied the brakes too early, and that made the crisis deeper, lasting longer, ultimately causing more damage and more costs to the taxpayer.

We believe that access to public support is a privilege, not a right. And when our Government provides support to banks, it is not for the benefit of banks. It is for the people, the businesses, and the families who depend on banks, for the communities that depend on banks, and it is for the benefit of this critical public interest in getting our economy back on track.

Government support, of course, has to come with strong conditions to protect the taxpayer and with the transparency that allows the American people to see the impact of those investments.

We believe our policies must be designed to mobilize private capital. When Government investment is necessary, it should be replaced with private capital as soon as that is possible.

And, finally, we believe that the United States has to send a clear and consistent signal that we will act to prevent the catastrophic failure of financial institutions that would cause broader damage to the economy.

Now, guided by these principles, we are going to move to help stabilize and repair the financial system and support the flow of credit that is necessary for recovery.

Last night, we laid out in a joint statement with Chairman Bernanke, with FDIC Chair Sheila Bair, with the head of the Comptroller of the Currency, and with the head of the OTS a statement of a program that brings all the financial agencies of our country together and a commitment to use the full force of the U.S. Government to help get our financial system back on track.

Our work begins with a new framework of oversight and governance covering all aspects of our financial recovery plan. These new requirements will give the American people the transparency they deserve, and they will build on what we have already done by posting the details of these financial contracts on the Internet, by restricting the role of lobbyists and politics in access to Government resources, and by outlining strong conditions on executive compensation. This is the beginning.

Now, under this framework we are going to establish three new programs to help clean up and strengthen the Nation's banks, to help bring in private capital to restart lending, and to go around the banking system directly to those markets that are critical to small business lending and consumer lending.

We are going to require banking institutions to go through a carefully designed, comprehensive stress test to strengthen their balance sheets, and we are going to introduce new measures to improve public disclosure. We are going to provide capital to help facilitate that process. This capital will come with conditions to help ensure that every dollar of Government capital assistance is used to generate a level of lending that is greater than what would have been possible in the absence of Government support. And this assistance will come with conditions that should encourage these banks to replace public assistance with private capital as soon as possible.

The second element of this program: Together with the Fed, the FDIC, and the private sector, we are going to establish a Public-Private Investment Fund to provide Government capital and financing, to leverage private capital, and to help get these private markets working again.

Now, providing financing the private markets cannot now provide, we hope to help restart a market for the real estate-related assets that are at the center of this crisis using a market mechanism to help value the assets.

The third piece of this program: Working jointly with the Federal Reserve, we are prepared to commit up to $1 trillion to support a consumer and business lending initiative, building on a program outlined by the Federal Reserve and the Treasury last fall. This program is designed to restart the secondary lending markets, the securitization markets, to help bring down borrowing costs and to help get credit flowing again. This program, as I said at the beginning, goes around banks. We have to both strengthen banks be-

cause they are central to recovery, but we need to go around them to help get the credit markets that are critical flowing again. And, again, these are targeted to the markets that small businesses and consumers depend on most.

In addition to these steps, and in the package now working its way through the Congress, we are prepared to take additional actions to make it easier for small business to get credit from community banks and large banks, with some improvements to and some additional authorities for the Small Business Administration.

Now, finally, in the next few weeks, the President and his team will outline a comprehensive program to help address the housing crisis. Millions of Americans have lost their homes, and millions more live with the risk that they will be unable to meet their payments or refinance a mortgage. And our focus will begin on using the full resources of the Government to help bring down mortgage payments and help reduce mortgage interest rates, and we are going to do this with a substantial commitment of the resources already authorized by Congress under the Emergency Economic Stabilization Act.

As I said, this program will require a substantial and sustained commitment of public resources. The Congress has already authorized substantial resources for this effort, and we are going to start by using those resources as carefully and as effectively as possible to get as much impact for those resources, at least cost and least risk to the American taxpayer.

As we proceed with moving forward with this plan, I want to emphasize that we are going to invite input from the public and suggestions and ideas from Members of Congress, and having the benefit of your ideas and expertise and concerns will, I believe, help us craft better policies, and we look forward to making this a truly collaborative effort.

Mr. Chairman, I want to just emphasize, as you did at the beginning, that for us to get the economy back on track, we need to move together on three fronts: we need to pass a powerful economic recovery program to help create jobs and encourage private investment; we have to move aggressively to try to get credit flowing again by helping to repair and strengthen the financial system; and we have to move to address this housing crisis. Very important that those things move together. The quotes you said at the beginning are absolutely right, that there is stimulus in financial repair and recovery. Without repair and recovery of the financial system, the financial system is going to continue to work against stimulus. We need to move on these three fronts together.

Finally, I just want to say a few words about the deep challenges we face on the budget front going forward. I have always been a strong proponent of fiscal responsibility. When I last served in the Treasury Department in the 1990's, the adoption then of fiscally responsible policies for our country helped create a virtuous cycle of economic growth, deficit reduction, ultimately leading to a budget surplus. Today, of course, we are experiencing a terribly challenging fiscal environment and a terribly challenging economic and financial crisis. And as the President says, the Government has to act to help solve this crisis. Inaction is not an option. But as we move forward with the type of programs we think are necessary to

fix this crisis, we are going to have to lay out for the American people and the Congress a set of commitments that bring our resources and our expenditures more into balance with a budget that achieves a sustainable position over the medium term, with a set of disciplines on budget process that will help achieve that, and with a commitment to work with you and your colleagues who have shown great leadership in this issue to address our longer-term fiscal challenges as well. That will be critical to the credibility of this program. But I also believe—and I think there is no escaping this—that if we are not forceful now, ultimately it will be harder for us to get our fiscal position back into a sustainable position because we will suffer from a greater loss of productive capacity, a greater erosion in our revenue base, and all those challenges will be more difficult to solve.

We are starting, of course, from a deeply—just a huge deficit and a hugely damaged system. But the most fiscally responsible course now, I believe, is to try to move aggressively together to address those problems, because ultimately it will be less costly to the American people than the alternative path, which is to be tentative and limited and gradualist in our basic approach.

Thank you, Mr. Chairman. I would be pleased to answer any of your questions.

[The prepared statement of Secretary Geithner follows:]

Secretary Timothy F. Geithner
Opening Statement
Senate Budget Committee Hearing
Policies to Address the Crises in Financial and Housing Markets
February 11, 2009

Chairman Conrad, Ranking Member Gregg, and Members of the Committee: thank you for inviting me to be here today, as Congress continues its work on an economic recovery plan to help create jobs and lay a foundation for a stronger economic future.

Right now, job losses are accelerating and credit has slowed to a trickle. On top of the financial and economic challenges we face… there is another: a lack of faith.

The American people have lost faith in the leaders of our financial institutions, and are skeptical that their government has – to this point – used taxpayers' money in ways that will benefit them.

Together we can change this.

Yesterday, I announced our Administration's plan to restart the flow of credit, strengthen our financial system, and provide critical aid for homeowners and for small businesses: the Financial Stability Plan.

To get credit flowing again, to restore confidence in our markets, and to restore the faith of the American people, we have proposed a fundamental reshaping of the government's program to repair the financial system.

It all begins with transparency. We propose to establish a new framework of oversight and governance of all aspects of our Financial Stability Plan. The American people will be able to see where their tax dollars are going and the return on their government's investment. They will be able to see whether the conditions placed on banks and institutions are being met and enforced. They will be able to see whether boards of directors are being responsible with taxpayer dollars and how they are compensating their executives. And they will be able to see how these actions are impacting the overall flow of lending and the cost of borrowing.

These new requirements, which will be available on a new website FinancialStability.gov, will give the American people the transparency they deserve.

Second, we are going to bring together the government agencies with authority over our nation's major banks and initiate a more consistent, realistic, and forward looking assessment about the risk on balance sheets. We are calling it a financial "stress test." We want banks' balance sheets cleaner and stronger. And we are going to help this process by providing a new program of capital support for those institutions that need it.

Institutions that need additional capital will be able to access a new funding mechanism that uses money from the Treasury as a bridge to private capital. The capital will come with conditions to help ensure that every dollar of assistance is used to generate a level of lending greater than what would have been possible in the absence of government support.

Third, together with the Fed, the FDIC, and the private sector, we propose the establishment of a Public-Private Investment Fund. This program will provide government capital and government financing to help leverage private capital and get private markets working again. This fund will be targeted to the legacy loans and assets that are now burdening many financial institutions.

By providing the financing that the private markets cannot now provide, this will help start a market for the real estate-related assets that are at the center of this crisis. Our objective is to use private capital and private asset managers to help provide a market mechanism for valuing the assets.

We are exploring a range of different structures for this program, and will seek input from this Committee as we design it.

Fourth, working jointly with the Federal Reserve, we are prepared to commit up to a trillion dollars to support a Consumer and Business Lending Initiative. This initiative will kick start the secondary lending markets, to bring down borrowing costs, and to help get credit flowing again.

In our financial system, 40 percent of consumer lending has historically been available because people buy loans, put them together and sell them. Because this vital source of lending has frozen up, no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small.

This lending program will be built on the Federal Reserve's Term Asset Backed Securities Loan Facility, announced last November, with capital from the Treasury and financing from the Federal Reserve.

And because small businesses are so important to our economy, we are going to take additional steps to make it easier for them to get credit from community banks and large banks.

Fifth, we will launch a comprehensive housing program. Millions of Americans have lost their homes, and millions more live with the risk that they will be unable to meet their payments or refinance their mortgages.

The President has asked his economic team to come together with a comprehensive plan to address the housing crisis. We will announce the details of this plan in the next few weeks.

Our focus will be on using the full resources of the government to help prevent avoidable foreclosures and to reduce mortgage interest rates. We will do this with a substantial commitment of resources already authorized by Congress under the Emergency Economic Stabilization Act. We welcome the ideas and input of this Committee in this important effort.

And finally, President Obama is committed to moving quickly to reform our entire system of financial regulation so that we never again face a crisis of this severity. And, again, that effort can only succeed with the collaboration and support of this Committee and other Members of Congress.

Chairman Conrad, I would like to applaud you for your longstanding leadership on fiscal responsibility matters. As you know, it is Treasury's tradition is to defend the integrity of policy, to respect the constraints imposed by limited resources, and to limit government intervention to where it is essential to protect our financial system and improve the lives of the American people. As Treasury Secretary, I take that charge very seriously and look forward to working with you and this Committee to address our fiscal challenges, both short-term and long-term.

Let me close by saying that our challenges in this financial crisis are more complex than any our financial system has ever faced, requiring new programs and persistent attention to solve. But the President, the Treasury, and the entire Administration are committed to working with you to see it through because we know how directly the future of our economy depends on it.

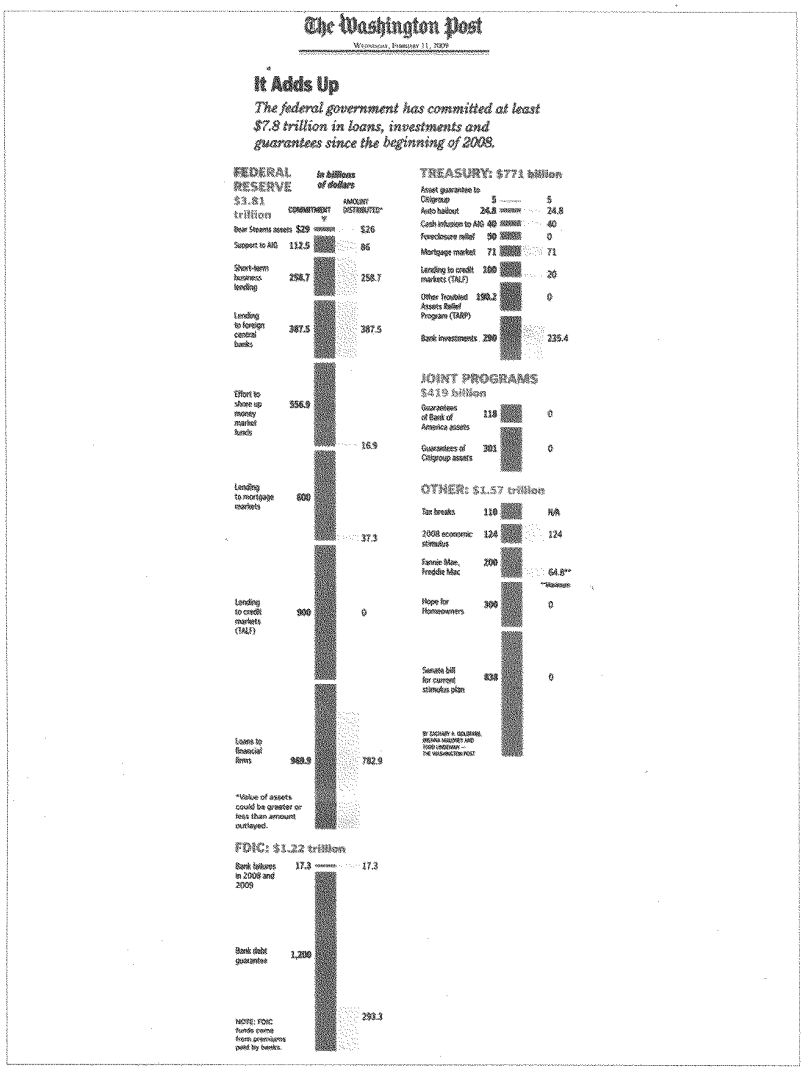
Thank you, and with that, I'd be happy to take your questions.

# # #

Chairman CONRAD. Thank you, Mr. Secretary, and I want to welcome David Vandeveer back to the Budget Committee hearing room. David served with distinction on the staff here for 6 years before joining your staff as a top aide, and we welcome him back to this Committee hearing room.

First of all, I got up this morning, read the Washington Post, and noticed that they had a column that they call "It Adds Up," and they talk about the Federal Government having committed so far $7.8 trillion in guarantees, investments, and loans to dealing with

this financial crisis—$7.8 trillion, and I think we should be swift to say that does not mean a full cost to taxpayers of $7.8 trillion, because much of that represents investments that will be, at least in part, recouped.



Part of it represents guarantees, and our history with guarantees is while they do cost money, they typically cost far less than the full amount of the guarantee.

I also noted with interest yesterday the Washington Post said that the cost of what you are talking about with respect to the financial sector and housing, $1.5 trillion. This morning, the New York Times, with another day to mull it over, came up with a very different number—$2.5 trillion. It is going up a trillion a day. At

least that is media estimates, and we all understand they are operating under deadline and with imperfect information.

You know, the obligation of this Committee and the primary responsibility we have to our colleagues is to try to give them the best assessment of what the budget exposure is going to be in the next year and the next 5 years and the next 10 years. And that is the reason we have the Secretary of Treasury come before this Committee, to help us understand what is the budget exposure.

I would understand if you are not prepared at this moment to give us a full picture of what that might be, but any indication that you can provide along those lines would be helpful to this Committee. As you know, we in just a few weeks need to present a budget outline to our colleagues.

So what can you tell us about what you see is the potential budget exposure of what you outlined yesterday?

Secretary GEITHNER. Thank you, Mr. Chairman. I want to begin by just emphasizing the point you made, which is that, you know, these numbers are very large. They are hard to understand. But the numbers you cited and are in this are predominantly, overwhelmingly loans against collateral and investments that come with a return to compensate the risk. Those broad numbers do not represent the costs in terms of budgetary resources, nor do they represent the additional borrowing into the country. And I think it is very important—and we will do this—to try to explain more clearly to people what those numbers mean, what is already committed, and what these new programs mean in terms of numbers, and to be careful and realistic to people about, again, what the ultimate cost is to the taxpayers in these programs.

A great strength of our country is we have a process with enormous integrity in CBO and the Congress and with OMB to try to assess the actual budgetary cost of these programs. I am deeply committed—we have been realistic—to integrity and candor to those estimates.

But the broad numbers do not represent the ultimate cost to the taxpayer nor the direct claim on taxpayer resources, because these are largely programs of lending against assets that come with some return to help compensate for risk.

Chairman CONRAD. So let me interrupt, if I can, on that point. Let me say to my colleagues, we are going to restrict the first round to 5 minutes apiece, given the large attendance here, and I am going to impose that same restriction on myself. So I have got 30 seconds left.

It is fair to say that the actual budget exposure is far less than the $1.5 trillion or $2.5 trillion that is in the newspaper headlines. Is that not the case?

Secretary GEITHNER. Absolutely. And as I said at the beginning, we are not coming before you today to ask for additional resources and authority. You have already authorized substantial resources. I think it is our obligation to use those resources carefully and effectively, again, to minimize the ultimate cost to the taxpayer, maximize the benefit to get credit flowing again. And the programs I laid out yesterday we can move forward on, on a substantial scale, within the $350 billion additional authorization Congress has

already provided. And those resources are in the budget baseline with a careful estimate by CBO and OMB of the ultimate costs.

Chairman CONRAD. So, just in conclusion, you in your outline yesterday did not call for any additional budget authority.

Secretary GEITHNER. That is correct, and I did that because I think not only have you already authorized substantial resources and it is our obligation to use those, as I said, as carefully and effectively as possible. But because we want to be careful before we come to you and ask for additional resources or authority that we have done so with as much care and consultation on design as possible. So before we get to that point, we will come with the level of detail and care in assessing ultimate costs and benefit that you need to do your job.

Chairman CONRAD. All right. Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman.

Just to followup, I have the same Washington Post article. It uses the figure $7.8 trillion, and it says that amount of money is equivalent to all the homes west of the Mississippi River. So I guess my question—can you explain to the average voter what this $7.8 trillion consists of? Some of it is from Federal Reserve. Some of it, I suppose, is the $700 billion TARP money that we have got and other moneys. And we do not have a lot of time, but succinctly, if you could explain where that money will come from.

Secretary GEITHNER. Well, Senator, as you said, this is a mix of different things. It includes the authority Congress has already provided under the Emergency Economic Stabilization Act, which has been used for capital investments, as well as smaller amounts of capital to help support broader lending programs. It includes a variety of guarantees and commitments made by the FDIC. It includes——

Senator SESSIONS. Have you got numbers, round numbers for each one of these that you are mentioning?

Secretary GEITHNER. Those are in the public domain, and I would be happy to provide as much detail as possible on the broad dimensions of that. The Chairman of the Fed yesterday committed to a greater process of transparency and disclosure on the Fed's piece of these programs. I think it is very important we lay that out, and I would be pleased to commit to laying that out in detail to this Committee. And I think the hard thing, of course, is not just to explain the composition of those numbers, but try to explain to people how we are protecting the risk to the taxpayer, what benefit they provide, because, again, our basic obligation—and I take this very seriously—is, again, to try to maximize the benefit we are achieving with limited resources, which as much care and protection for the taxpayer. And what is hard, of course, is, again, to try to provide a realistic appreciate of the risk in those programs. But it is important we do it, and I will provide as much comprehensive and candor and detail as we can.

Senator SESSIONS. Well, we know the Congressional Budget Office—I think my recollection is correct—scored the $700 billion TARP, the Wall Street bailout, as a $240 billion Treasury cost, and that Freddie and Fannie was about $200 billion to date, they have scored that. So each one of these things you would admit, every new program where it would not be dollar per dollar, will have and

should score by our independent Budget Office as a hit to the Treasury.

Secretary GEITHNER. I think it is critically important we have candor, independence, and realism to those assessments. I completely agree. But, again, the overwhelming obligation we face—this is a complicated financial crisis. We have got an incredibly large economy, a very large financial system, and our basic obligation is to try to use these authorities as carefully as possible but as forcefully to try to get the system repaired and recovery going again, because if we do not do that, the stimulus will be less effective, and we are going to face a deeper——

Senator SESSIONS. I understand that. I understand that, and you are saying we do not want to be timid and we do not want to be limited. But I do not want to be reckless, overspending, and unprincipled either. And so there is a tension here that we have to watch. And I know politically sometimes it might be better to say, well, we did everything possible and whatever goes wrong is not our fault because we acted boldly and nobody can blame me. But in the long run, those expenditures, those investments, those loans have to be consistent with our heritage of a free country, limited Government, and financial responsibility.

You say you will consult. We have had consulting around here, but nobody ever consults with me. I am not sure—they probably consult with our Chairman. But, I mean, when you say "consult," are you going to ask for legislation? Or do you think you already have power to execute the list of things that you have been talking about today?

Secretary GEITHNER. As I said, we have substantially authority and resources already authorized by the Congress to move forward on this front, and I think it is responsible, and it is our obligation to do that.

If we judge, if we believe that we think there is a compelling case for additional resources and authority, we will come to you and lay that out as quickly as we can.

Senator SESSIONS. I think I was in error. CBO scored the TARP at $189 billion, not $240 billion. But, at any rate, those are things that we do have to do, as the Chairman noted, figure out as best we can an estimate. Hopefully it will be less than that. It might be more.

Is my time up? Yes. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Sessions.

On our side, I just want to give Senators a heads up. It is Nelson, Cardin, Sanders. The first three on our side, Nelson, Cardin, Sanders. On the other side, it is Sessions, Enzi, Bunning, the first three.

Senator Nelson.

Senator NELSON. Mr. Secretary, I was surprised at the degree of criticism that you received from a number of the talking heads on TV this morning where they were saying there was a lack of specificity, and they were blaming the fact of the drop on the New York Stock Exchange and so forth. And I suppose that is a reflection that you came out with a balanced program, that it was not all going to Wall Street, that you look at this in a comprehensive way.

We constantly get it directly from our constituents who have had their mortgages foreclosed and so forth. So a lot of your, and I quote, "affordable housing support and foreclosure prevention plan is still yet to be developed."

Do you want to give us a few more specifics? And would you tie that into an issue that is before us right now? In the conference committee on the stimulus package, there is a $15,000 tax credit for the purchase of a home which is likely in the conference to be cut down to $7,500 tax credit. Tell us how that relates to what you ultimately will do on housing.

Secretary GEITHNER. Senator, this is going to be frustrating, I know, because I do not want to get ahead of the President on the housing plan. And as I said, I want us to get the details right and be careful as we do it. But let me be responsive to your question.

On where you ended, your colleagues are in the delicate process of consultations now on how to move this forward. My sense is they are making progress. There are some issues they have to work through. And we are very hopeful, though, that we are going to reach a broad balance that meets the President's objectives of a program with enough force to create 3 to 3.5 million jobs and help get the economy back on track. As part of that, there is a whole range of things that will be important to that, but those discussions are going forward now, and we are very hopeful they are going to make progress.

Now, on the housing strategy, I think the key elements of the strategy, as I said, are going to be to bring mortgage interest rates down, to help avoid the foreclosures that we can reasonably expect to avoid, to help bring mortgage interest rates down, and to try to bring more coherence, frankly, and consistency to the proliferation of initiatives to help support modifications across the financial system and across the agencies of the Government together. I think we have to do that together.

Senator NELSON. What is the mechanism to do that?

Secretary GEITHNER. We are going to do it, in part, by using Government resources to help incent and induce a level of modifications restructurings that will help, again, keep people in their homes and make mortgages more affordable.

Senator NELSON. And how do you value those mortgages? This is the big fight. Is it what they were or is it what they are worth now?

Secretary GEITHNER. Well, there is, you know, a deeply complicated set of valuation questions in any program like this, but in the housing plan, I think the core will be—and you have seen a lot of proposals out there in public by many people—to, again, try to induce economically sensible restructuring of mortgages, to help bring—using Government resources to help bring those payments down to a level that they are more affordable. That will allow the responsible borrower to stay in their homes. And you are going to have to do some complementary efforts to reinforce that by improving, strengthening Hope for Homeowners that Congress already passed last year. And there will be other things, too, that will be part of that.

But I think you have to look across that front and move together on that, but I do not——

Senator NELSON. How do you get the banks to go along with that?

Secretary GEITHNER. Well, you have to use a mix of incentive and persuasion, and as a condition for Government assistance in our new capital programs, banks are going to have to commit to adopt foreclosure modification strategies to meet a set of standards we lay out. That will help with persuasion. But you also have to do things that are going to help make it more economically compelling for them to do that, and doing that, of course, we just have got to be very careful to use the taxpayers' money carefully and wisely so that we are not benefiting people who do not need it or institutions in a way that is excessively generous.

Senator NELSON. On your first approach, financial stability trust going to the banks, you know that the community banks feel like they are being left out. What are you going to do about that?

Secretary GEITHNER. I know they do. I have met with them, have spoken to them, and I am committed to making sure we have the resources available to process their applications quickly, and the basic principle that is deeply important to me is that institutions receive fair treatment, equal treatment, they have the same access any other institution does, regardless of where they are and the degree of broad support they have for their—very important to do it because community banks largely were not part of this problem. They are going to be part of the solution. We need to make sure they have access on the same terms as anybody else, and that is going to require more resources so we can—you know, there are thousands of community banks, so we can move quickly to make sure that those who need it get it.

Senator NELSON. Thank you.

Chairman CONRAD. Thank you, Senator.

The order, Senator Enzi informs me, was not fair to Senator Alexander, that Senator Alexander is next. Senator Alexander?

Senator ALEXANDER. Well, I thank the Chairman, and I thank Senator Enzi. That is as rare in the Senate as an unexpressed thought, so I thank you for the——

[Laughter.]

Senator ALEXANDER. I thank you for the courtesy, Mike.

Mr. Secretary, welcome. We are glad you are here and look forward to working with you on this Committee as time goes on. I think Chairman Conrad was right on the money, so to speak, when he talked about housing, financial institutions, and with what money we'll use.

Here is my concern. The testimony to which the Chairman referred the other day was from three distinguished economists that we asked what to do about the bank part of the credit problem. And the estimates they gave were that there may be $2 trillion plus of bad assets in the banks. And then they recommended that whatever we did, we make it possible to get rid of those assets as quickly as we could to get lending moving again. We asked them how much capital a so-called bad bank—and I know that is maybe not a phrase that some like to use, but if we set up an entity to try to help get rid of those things, whether it is public-private, how much capital should it have? And the answer was, "Well, as much as you can put in it." There are some limits even to the Federal

Reserve Board's balance sheet, because either we are printing money, which means inflation down the road probably, or we are appropriating money, which comes from the taxpayers.

So I have got in my mind this notion of $2 trillion to get rid of the bad assets in the banks and that we have heard for weeks and months, which I believe, that until we address, we are not going to get lending moving again. We cannot just tell banks to lend to people who cannot pay it back or lend money they do not have, as good as that might sound.

So aren't you really underestimating the size of this when you say it is a trillion dollars and undercapitalizing the effort? And let me just go through the series of questions and give you the time to answer.

Wouldn't it be wiser and bolder and better just to come out and say: We have got a big problem, maybe $2 trillion or more with bad assets. Experience all over the world in situations like this is we need to get the bad assets out as rapidly as we efficiently can.

So we are going to need more money. We are going to need more money, and we are going to ask for it now. And I will have to say that, from my point of view—that is not the point of view on the other side of the aisle—I am still stunned that the President would ask us to spend $1 trillion, actually spend it on projects, on a so-called stimulus, most of which are not to create jobs in the first year. Why wouldn't it be better to cut that so-called stimulus bill in half, focus it on creating jobs in the first year, and set aside that $400 or $500 billion to help get lending moving, get housing moving, get the community banks moving? Wouldn't that even be a better stimulus if we said that? And wouldn't it be better to do it now rather than come back and ask for it? And I am one Republican Senator who has now voted twice for the TARP money because I thought President Bush needed it and I thought President Obama needed it.

Secretary GEITHNER. Senator, let me just begin where you ended and say that, you know, the scale of lost output ahead in this recession is very large, and it is very important that this recovery package be large enough to help compensate for that lost output. And I do not think it would be efficient or responsible to underdo that even though I agree with you completely that getting the financial system repaired and getting credit flowing again is going to be crucial to recovery.

So I think you are right, we need to do both, along with housing, but I do not think it would be sensible or ideal to underdo it on stimulus even though you are right that you need to use substantial resources for financial recovery.

Now, I also agree with you that it is important to be candid about costs, and as I said in the beginning, it is better to try to do more sooner than to stretch it out. But I want to be very careful not to come to you and ask for resources and authority before we have as careful and compelling a case as possible.

On the bad asset problem, it is critical in our country, as in any financial crisis, that we provide capital to institutions that need it. Now, our system is very diverse. There is a lot of strength in our system, and there are pockets of weakness where we have to be prepared to be helpful and supportive with capital, because that

will be powerful in its impact on the economy as a whole. And to do that efficiently, we have to help get these markets for these real estate assets going again.

Now, in a simple sense, there are two ways to do that. You can have the Government come in and buy the assets and manage them at a price the Government sets. That process carries enormous risk that we end up using the taxpayers' money inefficiently, take risks the Government does not understand, and my judgment is that ultimately will be costly, too costly.

The alternative mechanism, which I think is a better mechanism, is to try to use our resources more carefully with financing from the Government to help leverage private capital with a mechanism that is going to provide a more realistic and careful measure of the ultimate value and cost of these assets. And I think using that market mechanism will be more helpful, more efficient for our objective over the longer term. It is complicated to do, though, and we are going to try to get it right before we move forward. And that is one reason why we started with the general outlines of the framework rather than the precise details of the proposal.

But I very much agree with your basic instinct and judgments that better to be open about the costs, not underestimate them, move with as much force as possible, and just echo a comment that Senator Sessions made at the beginning about what the balance is between uncertainty and anxiety we create and between honesty and candor. And I believe deeply there is more reassurance in being candid than there is in its absence. And I will always try to come before you and be open with you about what the scale of resources are, ultimately what we are going to need, what the risks are, what the constraints are, what the alternatives may be, because I think it is important for our credibility and for yours that we are as open with those things as possible, and I will try to meet that test. But I cannot do that until we have had the chance to consult carefully on the broader design of the program and its ultimate cost.

Senator ALEXANDER. Thank you.

Chairman CONRAD. Senator Cardin.

Senator CARDIN. Thank you very much, Mr. Chairman, and, Secretary Geithner, thank you very much for your leadership and your appearance here today.

You have said that Congress did the right thing in giving the President the tools to deal with the financial crisis, including the TARP funding. There has been a general acknowledgment that the first $350 billion should have been used more effectively than it was used.

I want to hear from you briefly how you will do things differently. What lessons have we learned from the first $350 billion, so that we have confidence that the second half of those funds will be used in a way that will be more effective in relieving the credit markets?

Secretary GEITHNER. That is enormously important to me. We will not be effective unless we earn more confidence with you and your colleagues and with the American people that we are going to use these resources wisely. And so let me just give you my basic sense of what that is going to require.

The first really important thing is, again, we bring much higher standards for transparency and accountability so the American people can see how we are using the money and what impact it is having.

Senator CARDIN. Can I just stop you on that point?

Secretary GEITHNER. Absolutely.

Senator CARDIN. I believe I am quoting from your presentation, that you will guarantee a level of lending by those who are receiving the financial help. I am curious as to how you intend to enforce that. What enforcement is there to make sure that what the banks say they are going to lend is actually lent?

Secretary GEITHNER. Right. A very important issue, and thank you for asking me to clarify that. What we are going to do is, as a condition for assistance, ask the banks to give us a concrete plan for how they are going to use that assistance to generate a level of lending that is greater than what would have been possible in the absence of that support. We are going to ask them to report monthly on what is actually happening to lending relative to that plan and that commitment. We are going to put those reports in the public domain. They will be subject to independent assessment, not just by the congressional oversight body but by the Treasury Inspector General, by the GAO, so you will have a series of independent evaluations about, again, how that money is being used.

I think that is the right place to start——

Senator CARDIN. All that is positive. What happens if they do not reach the level of lending that is expected?

Secretary GEITHNER. Well, they are going to have to explain why that was the case, and there will be reasons why it was not possible for them to meet that commitment, because, you know, we are facing an uncertain and very challenging economic environment, and it is hard to know ex ante exactly what the demand will be from creditworthy borrowers for loans going forward.

You know, we had a huge credit boom. In recessions, demand for credit from everyone who is healthy and strong falls, and so the level of lending will naturally fall in this economy. What we want to do and what is critically important we do is it not fall more sharply, more acutely than that basic path. And that is why we have to make sure the assistance is directed at increasing the amount of lending that would have happened in the absence of that support.

But it is not just enough to try to make sure we attach those conditions to our assistance to banks directly. We need to go around banks——

Senator CARDIN. But are there sanctions if they do not meet expectations and there is a belief that they should have done better?

Secretary GEITHNER. Senator, some of the conditions that we are going to have to apply to this, we are going to—I mean, the conditions, we are going to have to make sure we enforce those conditions. But on the lending side, it is going to be a complicated process because, again, it is very hard to judge what the economically viable demand for lending is going to be in a recession.

Senator CARDIN. Let me just make a comment. When I was a lawyer in private practice, I negotiated on behalf of private companies to borrow money. If those companies did not meet certain ex-

pectations, there were sanctions that were imposed, including the pulling of credit, and other types of penalties.

I would feel more comfortable if I knew that if through this open process banks do not meet resonable expectations government is prepared to exercise sanctions against them. Not only are they receiving money at a very low interest rate these are Federal funds that come with public expectation and require accountability.

Secretary GEITHNER. I agree with you, and I want the conditions we establish to be enforced, and I want people to see how they are being met. But I just want to be candid that in this particular delicate area of lending, there will be things that will produce outcomes a little different from what their initial plans are, that we will not have the power responsibly to avert. But I completely agree with your sentiment that we establish conditions, and we want those conditions to be enforced.

Senator CARDIN. I thank you for that. Let me just say something positive in my last 10 seconds. Thanks for including small business. Thanks for being prepared to go into the secondary markets so that we can free up money for small business. I think it is desperately needed.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Enzi? And, Senator Enzi, thank you for being a gentleman previously, allowing Senator Alexander to go first.

Senator ENZI. Mr. Chairman, I should have been more expansive on that than I was. Actually, Senator Bunning was the first person here, then Senator Alexander, then me. So I would defer to Senator Bunning.

Senator BUNNING. That is all right. I understand.

Chairman CONRAD. I apologize, Jim, if we got it wrong.

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

Secretary WELCOME AGAIN. I am very interested in how you are going to value banks' assets in your stress test. This is the key to fixing the whole mess. What are you going to do with a bank that your stress test shows that they are insolvent? Are you going to close them, nationalize them, give them more capital, buy their toxic assets? What are you going to do with them?

Secretary GEITHNER. Senator, the supervisors of your country are working together now to bring a more careful, consistent, realistic assessment of the exposures on banks and try to make careful judgments about what the losses ahead are likely to be in the kind of challenging environment we face. And on the basis of that, where there are needs for additional capital, we are going to be prepared to provide that capital.

Now, Congress authorized in the wake of the S&L crisis a carefully designed process——

Senator BUNNING. Those savings and loans had already failed.

Secretary GEITHNER. No, but I was going to say something——

Senator BUNNING. I was here when it happened.

Secretary GEITHNER. I agree with that. I understand that. But I am just saying that the Congress does have and the FDIC does preside over a mechanism that allows for the orderly resolution of banks in our country. That process is being used today. It will be tested in the future. And I think it is very important that we be

careful in moving forward that we are facilitating the necessary restructuring of the financial system that has to happen.

Senator BUNNING. OK. Some of my colleagues talked about spending and how much we were going to spend. If my figures are accurate and those that add them—and this is what the Budget Committee will tell us very quickly—our spending is right about 20 percent of GDP right now. It was down to 18. The Bush administration drove it up to 20. According to everything that I have read and seen, by the end of fiscal year 2010, it will be 38 percent of GDP. To me, that is exactly what the European Union countries are at. Most of those countries are socialistic.

So what I am asking you is: What happens to our free market in comparison to running into socialism when and if we spend that kind of money?

Secretary GEITHNER. Senator, that is a level of spending we cannot afford as a country and it would be irresponsible. In the President's budget, which you will see in the coming weeks—and I will have the chance to come speak to you about it—will lay out exactly what we think is a responsible path for expenditures and what the path of revenues are going to be to support that and how we are going to meet this vitally important obligation of committing to bring our resources and expenditures more into balance and our budget to a more sustainable position.

That is hugely important, as I said. It is something that starts with the President's budget. It does not end with that. It is going to require we work together to make these hard choices, and the world will be watching to see whether we are prepared to make commitments now that will begin that process of bringing those resources and expenditures more into balance.

Now, we are doing in the financial sector things that we have not done before that raise deep concerns about the appropriateness of the Government role in the financial sector over time. I am very sensitive to those concerns, but we have to be very careful that we not go too far and that we design things in a way that allows the Government to get out of this and walk it back as quickly as that is feasible. But crises like this cannot be solved by the markets. They will not burn themselves out. And I think it is necessary and responsible, done carefully, for the Government to be willing to come in and take some risks that the markets cannot take now.

Senator BUNNING. I understand that.

Secretary GEITHNER. And in a very careful way that we can walk these back and unwind them as soon as we have got recovery firmly established.

Senator BUNNING. I have one last question. Yesterday I asked you if you believed that we have an independent Federal Reserve, and you said, "Absolutely, and vitally important to our country that we preserve that." That is what you said. But your plan has the Fed printing nearly $1 trillion to stretch your TARP money to buy asset-backed securities, which could result in a loss to the Fed, much like the Bear Stearns assets are now about $3 billion in the hole.

Do you think putting the Fed at risk to implement fiscal policy and save you from having to ask Congress for more money compromises the Fed's independence?

Secretary GEITHNER. I do not, and I would not do it if I thought there was a risk of that. And the Federal Reserve has independent authority provided by the Congress, and they will not commit to do things jointly with us if they believe it compromises that independence and that authority.

Senator BUNNING. Well, we will ask the Fed Chairman when he gets before us. Thank you.

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you, Mr. Chairman, and, Mr. Secretary, thank you very much for being here. I know we all look forward to working with you to address this horrendous crisis.

Mr. Secretary, as you well know, the American people are outraged that a small number of Wall Street executives, through their greed, their recklessness, and likely illegal behavior, have plunged us into the worst financial crisis since the Great Depression. We all know that millions of Americans have lost their jobs, their savings, their homes, their pensions, their health insurance, while the CEOs of the largest financial institutions in this country that caused this crisis are still holding on to their jobs. Millions of Americans lost their jobs. These guys who caused the crisis still have their jobs while over a period of years they made out like bandits.

Now I do not have a lot of time, so I would like you to, if you could, just give me a yes or no answer to the following questions.

In 2006 and 2007, Lloyd Blankfein, the CEO of Goldman Sachs, was the highest paid executive on Wall Street, making over $125 million in total compensation. Due to its risky investments, Goldman Sachs now has over $168 billion in total outstanding debt. It has laid off over 10 percent of its work force. Late last year, the financial situation at Goldman was so dire that the taxpayers of this country provided Goldman Sachs with a $10 billion bailout.

A very simple question that the American people want to know: Yes or no, should Mr. Blankfein be fired from his job and new leadership be brought in?

Secretary GEITHNER. Senator, that is a judgment his board of directors has to make. I want to say one thing which is very important. Everything we do going forward has to be judged against the impact we are going to have on the American people and the prospects for recovery. And every dollar we spend has to be measured against the benefits we bring in terms of——

Senator SANDERS. Mr. Secretary, you are not answering my question. You have a person who made hundreds of millions for himself as he led his institution and help caused a great financial crisis. We have put as taxpayers $10 billion to bail him out, and we have no say about whether or not he should stay on the job?

Secretary GEITHNER. No, I did not say that. I think there will be circumstances, as there have been already, where the Government intervention will have to come with very tough conditions, including changes in management leadership of institutions, and where we believe that makes sense, we will do that.

Senator SANDERS. Well, I just asked you do you believe that is the case with Goldman Sachs?

Secretary GEITHNER. In this case, I am not going to change my answer, but I want to just say one thing. I feel deeply offended by

the judgments you have seen these boards of directors make. I think they have made our task much harder going forward——

Senator SANDERS. But we are not going to fire the leadership, and we are going to keep these same guys who caused this crisis in power and who have made huge sums of money.

Secretary GEITHNER. Where we think that is the most effective strategy for our country, we will do that.

Senator SANDERS. All right. I have a strong disagreement. I think the American people, if they are going to pour hundreds of billions of dollars into these institutions, want a new slate of leadership so that we can work with them to move us in a new direction.

Second question, and Mr. Bunning raised the issue of the Fed. I will take it in a different direction. We all talk about the $700 billion in TARP funding that the taxpayers have put up. We do not talk too much about the $2.3 trillion of Fed loans that went out.

Now, every member of the Committee has engaged in huge debates on the floor of the Senate or the House, over $10 million here, $50 million there, should it go here, should it go there. We put $2.3 trillion at risk from the Fed. I have no idea, nor do I believe does anybody else here know, where one nickel of that money went, who got it, what the terms are, what is being repaid.

Will you make public or work with Mr. Bernanke to make public so that all of us will know who received this $2.3 trillion?

Secretary GEITHNER. Chairman Bernanke testified publicly yesterday that he is going to bring a new level of disclosure and transparency to the actions of the Fed. He believes in that. I think it is important to do. Happy to work with him on how best to do that. Happy to come testify with him together to try to make sure that on all these programs we are providing a level of transparency that——

Senator SANDERS. You did not answer the question. The $2.3 trillion went out. Now, how do I get some of that? How do the people in Vermont get online to get some of that money? They are all very curious. Who got that money?

Secretary GEITHNER. Senator, as I said, the Chairman of the Federal Reserve said yesterday that he is going to bring a new level of disclosure to those basic programs so that you will be able to see how they are being designed and used with a greater level of detail than is apparent today.

Senator SANDERS. Will we know who received the money?

Secretary GEITHNER. You will know what loans were made with what programs against what type of assets with what rationale, with what ultimate risk. But that is a judgment he has to make.

Senator SANDERS. Last question. I have talked to some economists who believe that what happened on Wall Street was not just reckless and irresponsible, that perhaps—we do not know it—at the highest level there may have been fraud, that these guys understood that they were pushing worthless paper.

I know you have been on the job all of 2 weeks, but what is your intention in terms of undertaking a detailed investigation of possible fraud and taking criminal actions against the people who caused this crisis?

Secretary GEITHNER. My intention, Senator, is to work very closely with Mary Schapiro. This is her responsibility, the SEC's broader responsibility, and we need to make sure they have not just the resources but the quality of talent and people necessary to bring a much more forceful, credible enforcement mechanism. And I think it is very important to do so, and I know she is committed to it, too.

Senator SANDERS. Thank you.

Chairman CONRAD. Thank you, Senator.

Senator Enzi? And before you start, let me just try to clear up the confusion about the rules of this Committee with a new year, and perhaps we all need to be reminded. The rules of this Committee are at the gavel we then have recognition of members based on seniority. So even if Senator Alexander and Senator Bunning were here before you, if you are here at the gavel, because you are senior you would command first recognition. After the gavel, it is based on time of appearance. So I think it is important to remind everybody. That is the rule, longstanding rule of this Committee. It is seniority at the tapping of the gavel. After that, it is time of appearance.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman, and I appreciate that clarification, and I also appreciate your incentive for punctuality. I think that makes a big difference in committees.

I would ask that my full statement be a part of the record.

Senator ENZI. I want to thank you for the answers that you have given, the very clear way that you have stated them. It is something that has been needed and will be needed.

One of the things that has to happen around here is we have to restore confidence in the American people, and we have a tremendous task ahead of us because people do not have confidence in Congress. We have not done much to improve that confidence in Congress. Part of it has been the speed with which we have done things and the size of the things that we have done. Nobody understands the size of what we have done, and since they have not been given an understanding of it, they hold it against us. But they already held a bunch of things against us. And so we are trying to overcome that.

We also keep talking about being bipartisan, but we do not act bipartisan. Bipartisanship is when people get together before a bill is drafted and talk about the principles that need to be in it, not wait until the end of the process and then try and buy enough votes to pass the bill. That is what we have been doing around here.

Nobody in America, I think, believes that we can spend the $700 billion or the $820 billion efficiently. When you think about how much we have been spending, that gets very difficult. And until we can convince Americans that there is a mechanism there, we are going to have problems. And Treasury has a problem of confidence as well.

Yesterday you made some presentations, and I read about how they were taken. No details. I hope we can give you a chance—and I think you have done some of that today—to kind of undo yesterday. But you talked about demanding loans from the banks, liquid-

ity. Isn't one of our problems that some banks have a lot of money to lend but they don't have any consumers that they would lend it to? That seems to be the way in Wyoming. They followed the rules. I think we only had one bank that had a problem, and it was not a problem due to the financial situation.

So how do you get that money out there to people that can actually repay the money? How do we get the money circulating again?

Secretary GEITHNER. Senator, I am glad you raised that question, and it points to the difficulty of working through these problems. As the economy slows, recession intensifies. There is an understandable realistic concern about what is going to happen to the borrowers on the other side of banks.

Realistically, the credit quality of borrowers is deteriorating, and we have to be careful as we try to solve this crisis not to force lending to people who cannot use those resources well and not to force institutions that do not have enough capital to make the kind of mistakes that got us into this mess. And that is why it is such a difficult balance.

But you are absolutely right that what is driving the contraction in the demand for lending is partly a sense of conservativism and care on the backs of borrowers, even creditworthy borrowers, and probably it is because you are seeing, you know, more failures across the country and more concern about possible failures across the country.

Senator ENZI. Well, we were also told that with the first TARP that that money would go to buy toxic assets. I think you were part of formulating that plan. And then America saw that we did not buy any toxic assets. Now we are talking about solving housing again, but we have not plugged in the details. When will we be getting those details? And why did you decide to make a presentation yesterday if you did not have those details?

Secretary GEITHNER. Senator, let me just go back to something several of you have said about my role over the last few years, including in TARP. I have been President of the New York Fed, not Secretary of the Treasury. As President of the New York Fed, I played a very, very active role in bringing a lot of creativity and action by the central bank to help limit the risk in this crisis at an early stage. I was also a very forceful advocate for the Government coming to Congress earlier to ask for the broader authority necessary to solve this crisis.

Your Government came into this crisis without anything like the authority it needed to act to solve a crisis of this magnitude, and the fact that that action came late was very damaging. I was very supportive of the judgment not just to go to Congress and ask for broad authority, but very supportive of the judgment that at that time, when the system was at the point of maximum peril, that the most effective way to stabilize things was to put capital institutions and to provide broader guarantees.

I think if we had not done that, if my predecessor had not done that, we would be living today with a much, much, much greater crisis today.

Now, it did not have as much impact as necessary, in part because the scale of the challenge was getting much, much greater, and the resources provided were not adequate to that; and in part

because, as many of you have said, there is a deep distrust and anger around how those judgments were made and how institutions have been responding to that. I understand that concern, and we are going to have to move together to fix that.

Now, yesterday I laid out a broad framework of principles and programs to help solve this crisis. I understand the desire for details. I understand the disappointment about the lack of details today, but part of the disappointment, as I said at the beginning, is because people were hoping we were going to do things that, in my judgment, would have been too generous and not responsible with the taxpayers' money. I did not want to compound the mistakes of the last 12 months where things were rushed out before they were ready and strategy had to be adapted because of that. Very important to me we do that. And if that means there is going to be disappointment with the level of detail until we get it right, I will live with that disappointment because it is better than the alternative.

Now, as I said, the President and his team are going to lay out the details of their strategy on the housing crisis very soon. A lot of that work is done with those details. There will be details in that program, and you will have a chance to evaluate the details of that program and see whether we have done enough in that context.

But I understand the concern with details, but it is because of the need for care and consistency and clarity that I laid out a general framework rather than details yesterday.

Senator ENZI. Thank you. That gives me more confidence.

Chairman CONRAD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

Let me followup where Senator Cardin left off. You know, if an American family takes out a loan with terms and conditions and they do not meet the terms and conditions, there is a consequence. And so the question for me, following up on Senator Cardin, is: Why would we treat the banks differently than we would treat average American families, especially when we have seen in the first tranche of these dollars that the lack of conditionality has led to some of the consequences we do not want to see?

Secretary GEITHNER. Senator, the first obligation we have, I think, is to make sure that the conditions that came with those initial programs were actually enforced and met. That is very important to me. Again, there is an elaborate set of independent oversight of those conditions to try to make sure—and where those conditions were not met, then we will take action to remedy that situation.

Now, going forward, again, our judgment is we need to have tougher conditions with a much higher level of basic transparency and accountability so that people can see who is benefiting from the resources, people can see the terms and conditions, people can see how they come in to use those resources, they can see whether they are meeting that basic commitment——

Senator MENENDEZ. And I appreciate, Mr. Secretary, having the transparency and the accountability. I applauded you yesterday at the Banking hearing on that. The problem is that you need more

than transparency. Accountability means nothing unless there are consequences.

Secretary GEITHNER. Agreed, and we are not going to rely just on transparency. We are going to make sure these conditions are met and enforced. I believe in that deeply. But transparency itself is also important because it is important not just to public trust, but it itself——

Senator MENENDEZ. We are agreed.

Secretary GEITHNER [continuing]. Can be very effective.

Senator MENENDEZ. We are agreed on that. But I think many of us are going to be looking for what is the mechanism of accountability at the end of the day.

Second, today's New York Times has a story about the banks who already received TARP money wanting to get out and repay the TARP money. And so that drives two questions for me.

No. 1, in fact, did they really not need the money that they are looking to repay it early? Is this a question—are they so committed to their culture that viability is second to reasonable conditions? And, third, are we in a set of circumstances that if they are healthy—and we hope for them to be—we will change—there is a condition that says that if they cannot repay for 3 years, as I understand it, are we willing to—out of their earnings, are we willing to review that if, in fact, we find them to be healthy and they want to repay and the taxpayer will get back their money and they will be on their way?

Secretary GEITHNER. Senator, my basic sense is that it is important for us to design these programs so that we create incentives for them to pay the Government back, to replace our resources, the Department resources, as soon as that is feasible. I think that will be—that is a necessary thing not just to protect the taxpayer, but to make sure that the Government's role in the financial system is not sustained beyond a point that is necessary.

So I view that it is largely a healthy thing, and I think going forward, again, we want to make sure we get these conditions right so that as markets stabilize and the economy gets back on track, they have very powerful incentives to help repay the Government. That will ultimately mean we have less risk and exposure, and we are solving this in a way that is ultimately going to be cheaper for the taxpayer.

Senator MENENDEZ. Do you think, though, that this desire to pay back—which is fine if they are healthy, but that some of what I read in the article was we do not like the conditions. So, therefore, if you do not like the conditions, either you needed the money to be healthy and stable and survive the present crisis, or you did not? And if you do, that reasonable conditionality—that the culture there is that viability is less important?

Secretary GEITHNER. I do not think it is feasible for people to repay unless they have the means and the resources to repay, which is another way of saying that until they are viable, they will not be able to do that, whatever they think about the conditions.

Senator MENENDEZ. Finally——

Secretary GEITHNER. But, you know, a good test of conditions is whether they are attractive or unattractive, and I think the sign that people want to replace that publicly held or private capital is

a sign that the conditions are tough. They are going to have to get tougher. We have got to make sure that balance is right. But I think it is basically a healthy thing.

Senator MENENDEZ. Finally, I think insurance companies play a critical role in our economy, both in the form of products they offer as well as the economic growth resulting from their investments. Is that a view that you share?

Secretary GEITHNER. I do believe that insurance companies play an important role in our financial system, absolutely.

Senator MENENDEZ. And, finally, I want to echo——

Chairman CONRAD. That was two "finallys."

Senator MENENDEZ. Yes, but my light did not go off until I said that "finally," Mr. Chairman.

[Laughter.]

Senator MENENDEZ. I just want to echo on the community banks what Senator Cardin said as well. We have several community banks that are at the heart of lending, and they have made requests, and they seem to be lost in the process.

Thank you, Mr. Chairman.

Secretary GEITHNER. And we will fix that, because community banks are a critically important part of our financial system. And, again, they will be an important part of the solution.

Chairman CONRAD. Senator Graham.

Senator GRAHAM. Thank you, Mr. Secretary. Let us try to make a budget here because I have got to go back to South Carolina and everyone here is going to go back to their respective States and give people some idea of what we are doing, how much all this is going to cost, and when it is going to get better.

How much is left in the TARP fund?

Secretary GEITHNER. Senator, I want to get these numbers right so just give me 1 second. I am going to look at the resources remaining relative to commitments.

Senator GRAHAM. This does not count against my time, does it?

Chairman CONRAD. Yes.

[Laughter.]

Senator GRAHAM. Hurry up.

Secretary GEITHNER. Can I be responsive, but can you—I want to protect myself from the——

Senator GRAHAM. Within $20 billion.

Secretary GEITHNER. I need to amend this to be careful if I got the basic numbers wrong.

Senator GRAHAM. Sure.

Secretary GEITHNER. But the Treasury Department staff inform me that the commitments made to date under the total authority Congress authorized totaled $387.5 billion. Now, again, that is not the cost to the taxpayer. That is the headline number using the——

Senator GRAHAM. That is the amount of money you have left to do something with?

Secretary GEITHNER. No. That is the amount that has been spent so that——

Senator GRAHAM. OK. Well, how much is left?

Secretary GEITHNER. Well, the balance is roughly in the $315 billion range. Now, we have already committed to you some of the resources——

Senator GRAHAM. Fifty billion is gone, right, because the stimulus package took $50 billion out to go to housing, right?

Secretary GEITHNER. It will be when we start to move forward on that program. That is right.

Senator GRAHAM. OK. So you take $50 billion off $315 billion, and whatever number that is, that is what you have got left to deal with, right?

Secretary GEITHNER. That is right, and——

Senator GRAHAM. OK. Now, slow down. With that amount of money, you have got to do a bunch of things.

Secretary GEITHNER. We do.

Senator GRAHAM. Like fix housing.

Secretary GEITHNER. No, you just took the 50——

Senator GRAHAM. Well, that 50—well, will housing be fixed without any new money?

Secretary GEITHNER. I do not know that 50——

Senator GRAHAM. On a scale of 1 to 10, 1, you will not need any money; 10, you are likely to need more money to fix housing——

Secretary GEITHNER. For housing?

Senator GRAHAM. Yes.

Secretary GEITHNER. I cannot tell you that at this point, but if we think there is a good case for doing it, we are going to come tell you how we are going to do it.

Senator GRAHAM. OK, good. So you have no clue.

Secretary GEITHNER. No, that is not fair, Senator. What I will not do is—even if you are frustrated by the absence of details——

Senator GRAHAM. See, I just do not believe that is enough money to fix housing and banking, and I just wish you would say that, because you are going to come up here and ask us for more money. I know you will. Senator Conrad said on the floor let us just get on with this thing. Let us tell people some idea of what awaits them.

Now, when it comes to banking, how much money will you need to fix the banking financial institution problem beyond what you have available to you today?

Secretary GEITHNER. As I said at the beginning, I am not prepared to make that judgment today. I am not going to come up to you and ask you for money where we are not prepared to support the request for details.

Senator GRAHAM. Right. Well, see, you asked for—somebody asked for $838 billion, and whoever designed that package I hope is not going to design the banking and housing package, because I am convinced that of this $838 billion, a lot of it is going to go to things other than creating jobs in the first year or the next 18 months. And I am convinced you take hundreds of billions of dollars out of that package and apply it to housing and banking. But that is a debate that seems to be over with.

You had two options about the toxic assets. You could buy them yourself, the Government could, and your main concern there would be the Government setting a price that is too risky for the taxpayer, right?

Secretary GEITHNER. Yes.

Senator GRAHAM. OK. The second option is that you could get the private sector capital off the sidelines, give them some guarantees, put a floor or whatever you want to call it, and let them set a price, right? That is the second option?

Secretary GEITHNER. Yes, it uses a market mechanism with Government financing to——

Senator GRAHAM. Right. The Government is involved. How much money would the Government save in the second option versus the first option in your opinion?

Secretary GEITHNER. It depends how it comes out, but we believe a substantial amount of resources.

Senator GRAHAM. What would that be?

Secretary GEITHNER. It will be dependent on the design of the program.

Senator GRAHAM. Hundreds of billions?

Secretary GEITHNER. How much we will save?

Senator GRAHAM. Yes.

Secretary GEITHNER. Hard to know if it is of that magnitude. But, again, we are going to be guided by how to reduce that risk to levels that are——

Senator GRAHAM. But you are confident that second option saves the taxpayer money?

Secretary GEITHNER. Absolutely.

Senator GRAHAM. Very confident of it?

Secretary GEITHNER. Absolutely.

Senator GRAHAM. Does it take longer to achieve the goal than the first option?

Secretary GEITHNER. I do not think so.

Senator GRAHAM. OK. Now, when it comes to going around banks, setting up a system that will lend money to small businesses, does that create a problem for us down the road in the sense that you are creating a competition, a Government competition with private sector banks?

Secretary GEITHNER. I do not think so. Again, these programs are designed, Senator, so that the economics of the lending will become unattractive as conditions stabilize. We have had a lot of experience in designing those programs. They are working quite well on that basis. So, again, as confidence improves and conditions stabilize, then demand for——

Senator GRAHAM. So you do not think—and I have 13 seconds left. You do not think that will hurt private sector ability to get back on——

Secretary GEITHNER. No, no. I do not think there is risk in those designed that will be crowding out——

Senator GRAHAM. I have 5 seconds left.

Secretary GEITHNER [continuing]. Other capital.

Senator GRAHAM. Now, last question. If I went home and told people you are probably going to have to spend $500 billion more to fix everything beyond what the TARP has, would I be in the ballpark or would that be ill advised on my part?

Secretary GEITHNER. I do not think it would be well advised on your part to put numbers on anything yet until we have a stronger

foundation for those estimates, and that depends on how we go forward.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. I cannot spring like Senator Graham, but I am going to try.

Nothing is more important, Mr. Secretary, to getting our economy back on track than gaining public confidence. Now, few developments have done more to harm public confidence in what is happening here in Washington than the news in the last few weeks of the financial institutions receiving Federal bailout funds paying out $18 billion in bonuses. That is money that was delivered in just the last few weeks.

The Senate has passed as part of the stimulus legislation a bipartisan amendment that I authored with Senator Snowe and Senator Lincoln requiring that the companies pay back the cash portion of the excessive bonuses within 120 days.

Now, the economic stimulus legislation is likely to be finalized today. My guess is it is going to be finalized in the next 5, 6, 7 hours. So my question is: Given the fact that the President, to his credit, called these bonuses "shameful" and time is short, where do you stand on getting a solution to the problem of these just paid excessive bonuses in the economic stimulus legislation?

Secretary GEITHNER. Senator, the President laid out last week a comprehensive program of conditions on executive compensation. Now, you personally have demonstrated great leadership and creativity in coming up with a different complementary approach. We have talked about that privately. Our staffs are working together. We would like to work with you on how to achieve that objective.

Of course, we want to be careful we get it right and we achieve what we were trying to achieve without, again, creating the risk that we end up in a situation where the taxpayer is at risk of losing substantial money going forward. But we would like to work with you on it and be as careful and as responsive as we can be to your objectives.

Senator WYDEN. I appreciate that. I think time is short. We are going to have to move very fast. Our doors are open. Senator Snowe and I want to make sure this is bipartisan, and we look forward to those discussions today.

The second question deals with the valuation of bank assets acquired by Treasury under TARP. In December, Secretary Paulson promised that the value of the preferred stock that Treasury got for TARP money would be at or near par; that, in effect, for every $100 that was invested, the taxpayers would get stock and warrants valued at about $100 under current market conditions. The Congressional Oversight Panel that looked at this said that was not the case. They said Treasury got assets worth about $66 for each $100 spent.

My second question is: What can you do now to revalue those? How would you go about revaluating them? And what is going to be done with respect to protecting taxpayers who deserve more for their money than they sure are getting in that first round?

Secretary GEITHNER. Very important question. Let me just start by pointing out that when CBO scored the ultimate cost to the taxpayer of this program, they acknowledged, as they should have,

that there is risk to the taxpayer and ultimate subsidy costs in these programs.

The second point that is important to say is that a definition of a financial crisis is the market is not prepared to take risks that are otherwise economic. We are not going to be able to help solve that crisis unless we are prepared to take carefully designed risks the market is not prepared to take. That means that everything we do, if priced against current market conditions in some circumstances will look like today at that snapshot, then we are giving a significant subsidy to those institutions. That is why, again, CBO looks carefully at what the ultimate cost is.

Now, what our obligation is is to set the terms and conditions on these programs going forward that we, again, minimize the risks to the taxpayer, ensure a fair return, and achieve the most benefit we can on our overall obligation, which is to try to repair the system and get recovery back on track. We will be very careful to do that, but everything we do, because this is a financial crisis, if you measure it through a snapshot today, there will be some programs that look like you are below the market as it currently exists.

Senator WYDEN. Let me see if I can get one other question in. I want to support you on your bad bank efforts. I think that you want to move in the right direction. But I am very troubled about the fact—and you certainly see this in terms of the business press, you know, right now where a lot of the experts say that there is not enough detail and enough transparency in terms of what is really out there in terms of these troubled assets. I have been looking at three or four articles just this morning in today's Wall Street Journal. Andy Kessler, somebody I respect, says your plan puts too great an emphasis on keeping existing banks in place even though they are just stuffed with these non-performing loans.

So what is going to be done to give the public a clear read on the problem's scope here? Because unless that is done, I think it is going to be hard to make your bad bank strategy go forward.

Secretary GEITHNER. I agree with you, and we are going to do our best. And we are going to get the supervisors together to try to, again, provide a more realistic, forward-looking assessment of these exposures with better disclosure. We are going to provide capital to help support that process. We are going to use, with as much care as possible, Government financing to help get those markets restarted again, which will help people come to a better judgment about the ultimate credit loss without the distortion introduced by the absence of financing today. And as I said, we have these lending programs carefully designed to go around the banking system to help provide the financing the market cannot do.

I think that complement of things is the necessary, essential mix of things, and we are going to be careful to lay out the detailed design issues to the public before we initiate so they have a chance to look at those details and provide feedback and input to those so that we are coming out with the best program at least risk to the taxpayer.

Senator WYDEN. Thank you.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Ensign is next.

Senator ENSIGN. Thank you, Mr. Chairman.

I want to followup on the idea of bailing out the banks, going back to Japan's experience. Many people believed that it was a big mistake what Japan did in creating these zombie banks. We heard the other day an economist say that if an institution, if a bank, if a company is too big to fail, then they are just too big.

Could you address the idea that we could be creating zombie banks in the United States, propping things up that should otherwise fail?

Secretary GEITHNER. Senator, thank you. Obviously, we are going to be very careful not to do that. But this is an enormously severe, acute, broader crisis, and so what is possible in normal times is not possible in a situation like that.

But you are absolutely right that our obligation is to make sure that we are not impeding the necessary restructuring of the financial system that has to happen because things got too far beyond gravity, and that is going to have to change.

Now, countries classically make two types of mistakes in financial crises. One is, just to paint it starkly, to make the judgment that these things will burn themselves out, the market resolves them on their own. They other type of mistake they make is to underestimate the size of the problem to try to obscure the level of costs and resources, hope that it will work itself out over time, and that ultimately the system will grow its way out of it.

Those are both important mistakes to avoid. We are going to do our best to avoid that, and we are going to try to bring the mix of more confidence and clarity to what these risks are with support in terms of capital and an aggressive program of financing options to help restart these markets. Our judgment is that is the best mix of programs. Doing it is enormously complicated. We are going to do it as carefully as possible. But we are very attentive to and sensitive to just the risks you pointed out.

Senator ENSIGN. Do you have any fear at all when we are talking about how big the stimulus bill is, 800 billion plus?. We also have the TARP funds. We know we have an omnibus bill coming up. We know we will have a war supplemental bill coming up. We hear talk about the health care system with revusions to the health care system that could be incredibly expensive. We just added a lot of money to the Children's Health Insurance Program then you count the whatever trillions that the Fed has put into this, and whatever trillions that they will do in the future.

Right now other countries are buying our Treasury bills. Their sovereign wealth funds are buying them up. Do you fear at all at some point that inflation will rise—that perhaps the rating agencies may even look at the U.S. Treasuries as maybe somewhat suspect because we have just taken on too much debt? As it was talked about before, before all this started, we were at 25 percent of GDP. And we are going to be at the 40 percent that was talked about before. Will that cause these countries to maybe not buy our Treasuries? If they do not buy our Treasuries, from what I understand it is over. Our economic system collapses at that point.

Secretary GEITHNER. Senator, you are absolutely right, and we have to be very, very careful as we go forward that we improve confidence, not reduce confidence, not just here in the United States but around the world, that we are going to have the will as a coun-

try not just to solve this crisis but to bring our resources and expenditures back into balance over time.

It is going to be enormously complicated because of how deep the hole is today. But I believe there will be more confidence around the world and more willingness to help to get through this if we are aggressive today.

It sounds like a paradox, but I think it is true. I think if we look to the world like we are not going to move together with a carefully designed program of support for the financial system and economy, then I think we face more risk, that they are going to look at our country and say, Gee, growth will be lower in the future, they will have less ability to earn a return to pay back these investments, and I think there is more risk in that strategy than the strategy we are embarked on.

Senator ENSIGN. Well, my last comment is that I look forward to the President's budget. I understand it is going to have some fairly significant cuts in it. I personally believe that we should have been offsetting some of the spending in this stimulus bill today. I think that would have been a better thing to do. There is a lot of wasteful spending, as we all understand, here in Washington, D.C. I look forward to working with the Administration, whether it is OMB or whoever else it is in the administration, to look at wasteful spending that we can cut. But one thing we should not be looking at right now is creating new programs for the future that might not work and which could lead us to question whether we can sustain this kind of growth in the future.

Thank you.

Secretary GEITHNER. I know the President shares that concern, as do I, and we have got to be very careful together that we are not doing things that add to expectations about increases in expenditures over time that will not be efficient and effective, and that will not be within our capacity to support responsible.

Chairman CONRAD. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman.

Mr. Secretary we are clearly in a fine mess right now, and I wish you well trying to help guide us out of it. But I have a fairly specific question I want to ask you, and I want to tell you why I am asking it first, because I think we have this problem, but I think it is one of three major problems that we have as Congress to look at. And of those three, this is the smallest problem. This is looking at a $7, $8 trillion problem right now. Coming fairly shortly behind it is a $35 trillion problem of unfunded Medicare, and not far behind that is the problem of ocean acidification and climate warming and a complete global change that has never been seen in the history of the human species on this Earth.

So we have three major significant problems to deal with. We have one supply of political capital to deal with them. And I am worried that that one supply of political capital is going to be burned up solving this problem and that by the time we are done with it a year or 2 or 3 from now, people will be so fed up with Government's response to this that we will not have the political capital to address those other things.

The thing that I see as most damaging to this country's supply of political capital is the lack of comprehension on the part of Wall

Street that the lives of luxury that they have been living that would make a pharaoh blush are completely inappropriate to a situation in which the Government is being asked to support that going on.

Now, what President Obama did I think was very helpful, and it was a very good first start, but it hits strongly three companies and only a few people. There are two levels: The main level seems to hit only three companies. The other level reaches more broadly.

I think that the support we are giving to these industries is very broad. People said the AIG support was really designed to protect Goldman Sachs and others. There is a network there, and I just worry that we have got to take this more seriously than we are right now. And the specific question has to do with the Wall Street Journal article a few weeks ago that pointed out that there is $40 billion in deferred executive compensation on the books of TARP recipients, and at the moment we have zero transparency into that, and there is zero chance of giving it any kind of a haircut going forward because we have created no mechanism that would allow us to even consider doing that.

When you consider the war we had in this Senate over somewhere between $18 and $35 billion to support our entire auto industry, the notion that $40 billion needs to be blown out into deferred executive compensation with, again, zero transparency and zero haircut I think really puts at risk the public support that we need to address not only this but other problems.

It is fine to look forward, but there is a lot of really, you know, heavy-duty stuff on these companies' books that executives have booked and salted away, either to dodge taxes, which deferred compensation does, or to provide specialized retirement packages that their employees do not enjoy. And I think that stuff is a lingering time bomb, and I really think we need to get at addressing it.

As a lawyer, I think you need to have some due process for those folks. You cannot just move in and take it away. But we do not have any process for doing that right now, and so I think we are on a collision course with a real problem if we do not deal with that, and I would love to hear your thoughts.

Secretary GEITHNER. Senator, I completely agree with you, and I share the deep sense of distrust and anger and outrage that has been created by the cumulative judgments of those firms and the boards of directors. And as I said in the beginning, I think that over a long period of time, compensation just got completely out of whack with no appreciate of risk, and we have seen judgments made as this crisis intensified that reflected, frankly, no judgment about the scale of the damage caused. And our obligation is to try to help protect the people who behaved responsibly through this crisis from being excessively damaged by the actions of those who were less responsible. And compensation is at the heart of that, and one of the most important things we have to do going forward is try to make sure we fix that system so the incentives are not so distorted again.

Now, you are raising a very important and——

Senator WHITEHOUSE. Focus for a second on the looking-back part.

Secretary GEITHNER. Yes, I am coming to that. You are raising a very important complicated thing. You are right, it is going to be hard to do. In the proposals the President laid out last week, we put some tough things in there that help mitigate that risk in circumstances where there was clearly misleading fraud in the institution. We are open to looking at ways we can do more.

I know you know the sensitivity and complexity of doing that, but I appreciate the problem, and I agree with you that our overall credibility and our ability to help solve these problems and the others will depend on how we respond to this here. Happy to work with you on it, listen to ideas. I do not think it is going to be easy, though.

Senator WHITEHOUSE. Thank you.

Chairman CONRAD. Senator Murray.

Senator MURRAY. Thank you very much, Mr. Secretary. We have heard the words "credibility" and "confidence" thrown around a lot here, and I do not think that is surprising. From my perspective, the efforts that have been made so far to strengthen our banks and unfreeze the credit markets and stabilize this housing market have really failed to generate any confidence with the American people or with the markets. And I agree with the statement that you made yesterday that the American people have sort of lost faith in the leaders of our financial institutions, and they are skeptical that the Government has used taxpayer money wisely so far that it will not really benefit them as taxpayers.

Beginning way back with Bear Stearns, we saw that the strategy that was orchestrated and executed by the Treasury was just a patchwork of programs and seemed to a lot of people arbitrary and sort of reactive. And when Secretary Paulson initially proposed the TARP, his focus very clearly was to remove toxic assets from the balance sheets of the banks, and it was not 10 days later after we approved it that the strategy shifted to capital injections and pivoted away from specific proposals, back and forth, and I think that really has eroded, you know, the public confidence and our confidence and the market's confidence.

I have to say I think the American people understand the magnitude of this problem. But I think what they do not understand is what the heck we are doing. And you have now put forward a new proposal, and I am trying to understand it, but I understand what all of us are saying to you today, and I would like you to explain to us why you think that this latest plan is prudent, fiscally responsible, and we are not going to change our mind in 10 days.

Secretary GEITHNER. Because we have laid out a broad program of initiatives that get at the core weaknesses in our system, all of them, not just one of them; because we are clearly committed to help strengthening banks, because without banks that are prepared to lend, you are not going to have recovery strong enough. We are going to help that process by bringing not just more realism and disclosure to the exposures on bank balance sheets, but through a program of, again, not just capital but a program that provides Government capital to leverage private financing to help get those markets working again. And as I said, we are going to go around banks to help get at those markets that are critical to

reviving markets for small business lending, for consumer lending, and other markets where we think the return is greater.

Now, that has to come with action on the housing front, as I said, and by moving together on all those fronts and by trying to be as forceful as possible, I believe that offers the best prospect of trying to repair this system more quickly.

Now, there are aspects of this that are going to have to adapt over time, but we are going to move on all those fronts, not individually, and that alongside stimulus gives us a much better prospect of arresting this and have the financial system in a position where it is supporting not working against recovery.

Now, I understand how hard it is for people to grasp—I understand the desire for details on how exactly we are going to do that, and we are going to provide those details in a way people can assess as we refine these plans. But as I said, I am going to be very careful not to put you in the position and put us in the position where we are shifting strategy, looking over here at one point, ignoring what is over here. We want to do it all together.

You know, it is not going to be easy. It is going to be messy. It is going to be uneven.

Senator MURRAY. We sort of wanted you to do the miracle overnight thing here.

Secretary GEITHNER. I would like nothing better than to offer to be able to do that, but I cannot do that. I think you are aware of that. But we are going to do it to the best of our ability, and we are going to keep at it until we fix it.

The most important thing we can do together is make sure that the world understands and the American people understand that we are going to keep at it, and we are going to do what is necessary. We are going to be prudent and careful, but ultimately it will be more effective, it will be cheaper to the taxpayer, it will cause less damage to the American productive capacity if we move forcefully on all those fronts together.

Senator MURRAY. What if we just were to do the stimulus and nothing else?

Secretary GEITHNER. Then the stimulus itself would be much less powerful. You are going to have the system, again, you know, pushing against recovery. You are going to have a deeper, more protracted recession. Unemployment will be higher. Hundreds of thousands more businesses will fail because of that. So it is absolutely essential not just to do very forceful recovery act programs for jobs and investment, but to do things that fix housing and get the financial system better. And it is not going to take—you know, it is not going to happen in weeks and months. It is going to take a sustained commitment and effort to do it.

Again, I want to just end on two points. I have tremendous respect for my predecessor. He did some very difficult, hard things. He did make judgments different than what I would have made and any of us might have made, but we did not stand in his shoes. And this country did not come into this crisis with an adequate set of resources and authorities to help respond, and that put us in the position as a country where we were chasing this crisis late to have the tools and ability to do it.

Very important that we do not make that mistake again, and, again, I want to emphasize again that this is hard because of the scale of the weakness we are seeing across the economy. And as those pressures deepen, the pressure on the financial system intensifies and these two things reinforce each other, and arresting that spiral has to be the dominant objective of policy.

Senator MURRAY. OK. Well, really quickly, Mr. Chairman, the taxpayers are holding the burden on this. Are any of your proposals going to require those banks or institutions to replace their current management?

Secretary GEITHNER. Senator, where we have done that already, where we think that is necessary to protect the taxpayer and get better outcomes, we will do that. But we have got to make a careful judgment, again, what is going to end up with the best outcome for the taxpayer and the best outcome for the overall economy. And we will make that judgment where we see it.

Senator MURRAY. OK. Thank you very much.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Let me go back to a couple of things that, for the purposes of this Committee, are critically important for our functioning. In the TARP, there is, as I calculate it, $313 billion remaining. You take out the $50 billion that is committed to housing; that leave $263 billion. By all accounts in terms of the testimony before this Committee by some of the most respected economic analysts in the country, that is not going to be sufficient to deal with the financial sector.

You have been very careful here today not to provide more detail with respect to additional costs. I am not going to press you today, but I want to give you a fair heads up that this Committee, it is incumbent that you very soon help us understand if additional funds are going to be needed and in what amount. Can you give us any idea today when you might have greater clarity with respect to the costs of dealing with not only the financial sector but the housing sector?

Secretary GEITHNER. Senator, we will do it as quickly as we can. Part of why we are being careful is we need to assess the overall needs, which is the process underway, the supervisory undertaking. Part of it depends on how we design these facilities to make sure we are leveraging every dollar of public capital to get the maximum benefit. And as we go through that process, we will be in a better position, and we will do it as soon as possible. I completely understand——

Chairman CONRAD. Can you give me some—here is the very practical problem we have got. The very practical problem we have got is we have got to produce a budget for our colleagues in the next several weeks. And, you know, we have been through a circumstance in which we had these magic asterisks for the war, and the previous administration would tell us, well, we cannot tell you how much that is going to be, and they would put in zero. That is not going to work. We cannot put in—we knew the right answer was not zero about the war, and I do not believe the right answer is zero with respect to the housing crisis and the financial sector.

Can you give us any greater clarity on when you might have a better idea?

Secretary GEITHNER. Well, we are going to move forward very quickly to come out with detailed design elements on these proposals I outlined yesterday. We expect to be able to do that over the next several weeks. And that will at least give you a sense of how we plan to use the existing authority we have, and that will give everyone a sense to look at what those ultimate risks will be, and that will give us something at the beginning of the process for looking at whether we need to go beyond that and when.

I think it is important to point out that even those crises in history that were handled well and we look back with affection and admiration for how quickly and decisively they were, you know, they came in waves because—not because people were being too tentative, just because, you know, realistically you will not know with full clarity. So we face that basic tension of reality and will—but completely understand your imperative, and we share it, and we will move as quickly as we can.

Chairman CONRAD. Well, I appreciate that. Let me go to something else that is of great concern to this Committee, and that is the unsustainable course that we are on as a Nation. We saw a doubling of the debt in the previous administration. We now look ahead and see the potential for another doubling of the debt within a debt approaching 100 percent of gross domestic product, looking at the gross debt, 100 percent of gross domestic product by the end of this 8 years. And we have got the baby-boom generation, and that is not an estimate. They have been born. They are alive today. They are going to retire. They are eligible for Social Security and Medicare.

The President has called for a fiscal responsibility summit, and he is talking about doing that sometime this month. My own belief is—Senator Gregg and I have come forward with a proposal of a task force, bipartisan in make-up, with everything on the table, with the assurance that the product of the deliberations of that task force would actually come to a vote.

Now, I will be clear. There are members here, there are other committees, who strongly resist that approach. They want to go through what is called the "regular order." We have had detailed testimony before this Committee, including former Chief of Staff of the President of the United States Leon Panetta and many others have said, "You wait for regular order, you are going to be waiting a long time."

The problem with regular order is we are in silos. Frankly, I think that is part of the problem with the design of the economic recovery package. You have got appropriators working in their standard approach. You have got the Finance Committee, Ways and Means Committee. You know, unless you bring it all together, not only for the committees of Congress but for the American people, you lack the sense of urgency that is needed to actually reach conclusion on what to do.

Can you tell me what your basic disposition is with respect to taking on these long-term imbalances that represent not only the entitlements but also the revenue system of the country, the need for tax reform?

Secretary GEITHNER. Senator, the President shares and I personally share your judgment about the imperative, and it is going to require a different approach if we are going to solve that. And we are going to work with you in designing a process that offers the best prospect of bringing recommendations and judgments quickly, commensurate with the urgency of the problem and the scale of the challenges, so that we can, again, improve confidence that the American people are going to make these judgments going forward. And it is going to require a fundamental change in approach because I do not see realistically how we are going to get there through the existing mechanisms.

Obviously, you have put out a creative proposal for how to do this in terms of process. I know the President has talked to you personally about this. A lot of people in the President's—and I have been looking at this and other alternatives. He is going to try to bring people together and find a process that works. But I absolutely share your commitment to it, and it is going to require—you know, these things are not just driven by demographics. As you know, they are driven by what is happening to health care costs, and we are going to have to look at a comprehensive approach not just with discipline on the medium-term budget and a set of rules and disciplines on budget process to enforce that, but we are going to have to start a process sooner that helps deal with the longer-term challenges you laid out. Completely agree with that, and I think it is going to be critical to the success of recovery, too, because, again, if people do not believe that we are going to have the will and the ability to walk this back and address these longer-term challenges, then our efforts will be less effective. They will become less confident. As you said at the beginning, people will save more because an expectation that there are commitments ahead that we have not been able to meet.

Chairman CONRAD. We had testimony before this Committee by Allen Sinai, whom I think you know well, one of the more respected economists in the country. He told this Committee very clearly, "If you do not deal with the long-term imbalances, our country is going to look like a Banana Republic." Now, he said—this is a caricature of a response, but he said the harsh reality is if you look at the bow wave and the buildup of debt, the increasing need to finance that debt abroad—last year, of all the new debt issued by our country, 68 percent was financed by foreign entities. I mean, if this is not a warning signal to us that we are on an unsustainable course—and, by the way, we have had Mr. Orszag, who is now the Director of the Office of Management and Budget for this administration, he sat right where you are sitting and told us a year ago it is unsustainable. We have had every Secretary of the Treasury of the last three sit there and tell us we are on an unsustainable course. We have had the head of the General Accounting Office, Mr. Walker, tell us we are on an unsustainable course. We have had economists of every philosophical stripe sit at that table and tell us we are on an unsustainable course. And I believe it. And I personally do not want to be part of any papering over or slipping by or not facing up to—I have been here 22 years, and I do not want to be part of not facing up to what I believe is a fundamental threat to the economic security of the country.

So I very much welcome your offer of working together. I think it is imperative that we do. I want to invite you back to the Committee when you have greater clarity with respect to any short-term additional costs we are going to face with respect to recovery, assistance to the financial sector and housing, and I very much will want you to come back and talk to us about these long-term processes.

Senator Gregg, who is now, as you know, up for consideration for Commerce Secretary, and I concluded several years ago you have got to have a process. If you lead with policy, you are dead here. You are dead here. You have got to have a process that leads to a policy and a policy that can get voted on. If we do anything else, I think history shows us very clearly just forget it, because if you lead with policy in this town, every special interest group in this country will be knocking down the doors of our colleagues.

So, with that bit of wisdom, I will turn it over to Senator Sessions.

Secretary GEITHNER. Senator, could I just say that I agree completely with everything you said, but can I bring a tinge of optimism? We are——

Senator SESSIONS. Good. I am looking forward to that. Our Budget Director for a while was named Mr. Sunshine.

[Laughter.]

Secretary GEITHNER. As I said, I think there is more reassurance and candor than there is in its absence. But, you know, we are a strong country. This is about will, not ability. And throughout our history, when we face challenges like this, we have acted together to lay out a path out of it. And that is why we are as strong as we are today, and we have a history of—because when faced with a crisis, we have acted to fix it. And people want to see us do that. And I think the world is watching, and they want to see us come together and do that. And cannot do it—Treasury cannot do it alone. The President cannot do it alone. It requires the Congress together, and I think your basic instinct, of course, is right that it is going to require a change in approach.

Chairman CONRAD. You know, this is exactly what I tell audiences back home because, look, the news is tough. It is tough. We know we are in a tough economic circumstance now. We know that we are on an unsustainable course. But if you look back at the history of this country, the challenges that the people of this country have overcome, whether it was World War II, the Great Depression, all the other conflicts that we have faced, over and over this country has risen to the challenge. And it will again. It will again. But it needs leadership. It does need an optimistic outlook and an understanding that we can do this. And we can.

But to do it, we have got to be honest with people about the dimensions of the problem, and we have to act. And I especially welcome what you have said here today. This is not for some timid response. This requires strong action, determined action, and it is imperative we get it right.

Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman. You have been at this for several years now, and I do not think that there is anyone who more deeply understands it. Your leadership in getting us

through this difficult time is going to be critical, and you can be sure that on most matters you suggest, you will find a very enthusiastic supporter in me. And in the commission idea, I also believe we have got to do that, and hopefully we can make progress on it.

I just want to say a couple of things that really trouble me. The budget deficit from 2004 to 2007 had fallen from about $400 billion to $161 billion. Then President Bush sent out $163 billion in checks. That helped jump the budget deficit last year to $455 billion. Well, that is just 455. But that is the largest deficit we have had in the history of the Republic, the largest not in terms of GDP but in real dollars adjusted for inflation. So that is a huge, huge number.

This year, Mr. Geithner, it will be $1.5 trillion, according to CBO. They are scoring without the stimulus plan the budget deficit to be $1.2 trillion. When you add in the amount of money that will be spent out of the stimulus they are estimating about $1.4 to $1.5 trillion—that is three times the largest amount in history. And President Obama said to us in conference and he said to the Democrats and publicly that he understands we have a systemic problem, and I agree, and that we need a long-term solution. And he is saying things that seem to support Senator Conrad's idea of thinking tough about the future.

First of all, I want to say that he will never, ever save $800 billion we spent yesterday when we passed that bill. Not in his 8 years, if he stays in office 8 years, I do not believe you can cut entitlements, Medicare, Medicaid, $800 billion. That money is out the door. It is going to increase the deficit by $1.2 trillion scored over the 10-year budget window. So I just want to say that.

One writer wrote a book in 2006 and predicted the financial housing collapse, used a word about economies and countries when they collapse, he said they "invoke the old verities while doing just the opposite." We talk about balancing the budget. We talk about sound dollars. But the policy we have got in place here to fix it is not consistent with the ideal policies we want to have.

Now, you are saying we have got to do it in the short run because the crisis is so severe. I understand that. But I know—and I think you know—we are spending more money, and in the long run we ought to be spending less. And that is a problem.

You indicated earlier that we did not come to this crisis with the tools and resources to respond effectively. My belief is that the better thing to have done would be not to have allowed it to happen, to have prevented it. Senator Conrad and I believe Senator Isakson proposed in this stimulus bill that we have something like a 9/11 Commission so as the matter cools off and the American people are looking at it we can figure out, what mistakes did we make, how could they be avoided in the future. But, unfortunately, that proposal was not accepted. So maybe somehow we can get this done, but I really believe it is important for all of us to honestly know.

Now, you said maybe last summer you saw real trouble ahead. Is that right?

Secretary GEITHNER. Senator, this crisis began really in August of 2007. You could see the early signs of it happening 9 months before that. And I was a very aggressive supporter of action back then to move to address this, and the things that I was responsible

for help shaping them, if you look back at them, they did move very aggressively.

Now, the central bank——

Senator SESSIONS. We do not want to throw blame, but I think it is important for you to have your say about that. So you saw some things that could have been done sooner.

Secretary GEITHNER. Absolutely. But I think you are exactly right that the critical challenge is to make sure that we have a system, we build a system that is less prone to future crises, and to do that you cannot just rely on having better authority to manage the crisis when it happens. You have to have much better disciplines and constraints in place ahead of time. And there were systemic failures in our process, including by supervisors and regulators, and although I did, with my colleagues in the Fed, a lot of effective things in the years leading up to this crisis to try to contain the damage, those efforts did not have enough traction. I will say that honestly to you today, and across the system more could have been done in advance.

I completely agree with what you said about the importance of there being a brutally honest, careful, independent assessment of what those weaknesses are. I think just to use the word again about credibility, I think that one of the strengths of our country and a critical test of credible institutions is: Are people willing to allow there to be an independent assessment of what those failures are? And there have been already a number of independent efforts done to do that, but I think more will have to happen, including those focused on what happened in supervision. That is a necessary basis for trying to make sure that we come to you with a set of reforms that will prevent this from happening in the future.

I just want to come back again to where you began, which is that we are starting with this deep fiscal hole, $1.2 trillion. And I know people are skeptical we have the will to gather this going forward. But we have to spend more now in order to improve the prospects we are going to be spending less later.

There is no way this will solve itself on its own. These things can only be solved by governments acting to help stimulate jobs and stimulate private investment and help get the financial system working again. And so the best conservative, prudent way, fiscally responsible way to go forward will require necessarily additional spending and tax cuts now if we are going to solve this.

I do not think there is any way through it, and I think that is the responsible path to proceed, because, again, if we do not do that, we are going to face more damage to our productive capacity. We will be growing more slowly in the future. Recovery will be delayed, the recession much deeper. Human cost damage will be much more profound, and we will be in a much poorer position to address those long-term challenges that are going to be so important.

So it is hard to say it, but it is true. And I do not think there is a better path forward, again, than to try to be forceful now. I think that is the more prudent path.

Senator SESSIONS. But the Congressional Budget Office, our Budget Office, has given us a grim but I think honest analysis. They say that the stimulus package we are passing right now, are

in the process, would provide benefit to the economy for 2 to 3 years, but over a 10-year period, because of crowding out of private borrowing and increased interest debt payments that we are going to have to make over that period of time, they score it as a net loss to GDP over 10 years. And we know the next 10 years, where we will be having probably a $400 billion interest payment on that debt, and the stimulus long since having been passed, so the question is: Is this a smart targeted bill? Nobel Prize Laureate Gary Becker wrote yesterday, he thought the stimulus was pretty low in the bill and was critical of it.

So I just want to say there is no money to waste, and we are going to carry—our children will carry this debt. Every dollar needs to be wisely spent, and I appreciate the difficulty you are in. Keep the cost as low as possible and do us some good.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator. Thank you Mr. Secretary. Thank you for being here today. Thank you for your testimony. I think hopefully this will help the American people understand the course and the direction that we are on and that there is going to be not just one step—I think it is very important the American people know with great clarity that this is not going to be solved with one step. There are going to have to be many significant steps taken for us to be rebuilding for recovery, and we can do it, but it is going to take real effort. And all of us are going to have to pull together. That was your message here today. It is a good message.

Senator SESSIONS. Mr. Chairman, could I correct one thing?

Chairman CONRAD. Yes, sir.

Senator SESSIONS. I said there would be a negative GDP. What the report said was that GDP would be lower over the 10-year period if the stimulus bill passes than if it would not have passed.

Secretary GEITHNER. Senator, I just want to respond to that. I will look at the details of the report, but I do not think that is right, and ultimately what happens to the economy over time depends on what we do going forward to revenues and expenditures to bring our resources and commitments more into balance.

Now, if we did nothing except pass stimulus, then you are right. We are going to be living with a deeper burden over time, which will put some broader weight in the economy. That is why it is going to be so important to follow the recovery act with a budget and a budget process that not just gets that medium-term deficit down over time to a level that is sustainable, but that we begin this process soon of working together on the design of a strategy to help address those long-term problems. But it really depends on what we do going forward, and so I do not think it is right to say that growth will be lower in the future if we did nothing—it will be higher in the future if we did nothing today. That cannot be the case. I am certain of the fact that if we do not act today, growth will be lower in the future, and dramatically lower in the future.

Senator SESSIONS. Over 10 years is what they say, Mr. Geithner, and they crunched the numbers. I assume you have not personally crunched the numbers on that.

Secretary GEITHNER. We will be——

Senator SESSIONS. Well, let me just ask this. When you borrow $800 billion and interest over that 10-year period will make it $1.2 trillion, and you take that much money out of the sector, it crowds out other borrowing—would you not agree?—which has a detrimental effect on the economy. And you have to pay an interest charge of $347 billion over that 10 years. So there are costs. Nothing free here.

Secretary GEITHNER. Absolutely.

Senator SESSIONS. The cost of stimulating the economy today has a long-term cost in the future.

Secretary GEITHNER. Well, recovery today will produce more growth not just in the near term, but in the future. But addressing the challenge and the concern you just laid out, which is very important, requires that we follow the recovery act with a plan to bring our resources more in line with—so we are living within our means sustainably. And if we do not do that, you are absolutely right, we will be living with higher interest costs, greater burdens on Americans, and that will work against growth in the future. But that is just making the point which I completely agree with, and you have shown great leadership on these questions, too, that we move quickly to lay out what that path is with a credible process and commitments for achieving it. It will be critical to broader confidence in our programs.

Chairman CONRAD. Thank you again, and thanks to all members. We had very good participation today. I am glad everybody, virtually everybody had a chance to get their questions addressed. And, again, Mr. Secretary, thank you very much for your patience here today and for, I think, the important message you delivered.

Secretary GEITHNER. It is a privilege to be here. I look forward to doing it again and again.

Chairman CONRAD. And again.

Secretary GEITHNER. And again.

[Laughter.]

Chairman CONRAD. OK. We will stand in adjournment.

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

Michael B. Enzi

Statement for the Record

Of Senator Michael B. Enzi (R-WY)

"Policies to Address the Crises in Financial and Housing Markets"

02/11/09

Senate Committee on the Budget

Thank you Mr. Chairman. I apologize to you and my colleagues if I sound a bit hoarse today, but I've been shouting from the well of the Senate since last fall that we need to address the housing and financial markets first if we have any hope of emerging from this economic crisis. The trillion dollar stimulus bill that passed the Senate yesterday has no chance for success if we can't get these two sectors of our economy working again so I'm pleased we're finally sitting down to discuss real ideas.

Treasury's new proposal to bailout our financial sector was crafted by officials within President Obama's Administration over the last month. But the details of this plan were not released until yesterday. Some details are still lacking. I expect some changes

must be done legislatively, especially pertaining to the foreclosure crisis. I also expect you, Secretary Geithner, and President Obama to return to Capitol Hill to ask for more money in the near future. I intend to use that opportunity to assess the proposed program and address major problems with the current process.

Congress must be kept informed about the actions taken by the Treasury. So far the TARP, under Treasury, and the Federal Reserve's use of the discount window and lending facilities have been subject to a murky rulemaking process. Trillions of dollars in guarantees and billions more in direct investment have been made by the federal government with little input from people outside the Treasury and Federal Reserve. A Bloomberg article from Monday quoted the federal government's commitment to the financial crisis, through spending and federal guarantees, at $9.7 trillion. The truth is that no one knows exactly how much money has already been spent, and that must change. I am encouraged

by your proposal of stronger oversight and a public website to disperse information about your progress. But we don't need talk, statements, promises. We need actual details. The American people need to know where their money is going.

Any additional financial commitments must be wisely spent. Elizabeth Warren, chair of the Congressional Oversight Panel for the TARP, stated last week that the Treasury overpaid for bank assets with the first tranche of TARP funds by $78 billion. This is unacceptable. Treasury unintentionally subsidized banks for their investment by 30% and, in doing so, exposed taxpayers to liability not intended by Congress. Secretary Geithner, market analysts say that you could need up to $3 trillion more to get the "toxic" assets off of banks' balance sheets. Whether you ask Congress for a $1 trillion dollars or $1 dollar, that money must be accounted for and taxpayers must be protected from the growing liability of this program.

Ensuring that the taxpayers get what they pay for means Treasury must adequately price these bad assets in the market. Despite rhetoric to the contrary, pricing toxic assets is possible, and was actually done for assets held by Wachovia, Indymac, and others. The problem is that banks just do not want to sell at such a steep loss. Well, it is time everyone face economic reality.

I would like to enter into the record an article from the Febrary 3, 2009 edition of the Wall Street Journal written by Mr. Robert Pozen. In it, Mr. Pozen argues that the Treasury should take a discount in the purchase of toxic assets, provide banks with capital certificates equal to the difference between the discount and the estimated current value of the asset, and allow both the banks and the taxpayer to share in any profits from a future sale. This plan provides an incentive for banks to sell their assets and protects taxpayers from any long-term liability. I think this idea is

worthy of consideration and I would appreciate the Secretary's thoughts on it.

I am encouraged by Treasury's push to attract more private investment. Providing incentives for private investment in the housing and financial markets is the only way we can get our economic machine running at full speed again. However, you have provided no details about this plan. We need to hear more.

While I was a member of the Senate Banking Committee, I worked on the Terrorism Risk Insurance Act, a bill to temporarily subsidize terrorism insurance rates after 9-11. Unfortunately, TRIA had the effect of driving out all private investment permanently. TRIA has become a permanent fixture in the market, and the taxpayer shoulders that liability. Secretary Geithner, I strongly urge you to take the lessons of TRIA to heart.

The end game of a federal bailout must be a return to a fully-functioning, private market.

Treasury must improve the administration of the TARP program and how taxpayer dollars are invested in our weakened financial sector. Banks must get over their fear of selling overvalued assets at a loss, and Treasury must work harder to incentivize private investment back into the marketplace. Secretary Geithner, I would like to hear details about your strategy for accomplishing this.

How to Value Toxic Bank Assets

By Robert C. Pozen

The Obama administration is reportedly developing a plan to buy from U.S. banks some of their "toxic" assets—troubled debt securities backed by subprime mortgages or complex derivatives. Many commentators agree that banks will not ramp up their lending until these assets are taken off their balance sheets.

However, the purchase of these securities faces a major challenge—no one really knows how they should be priced since most have not traded for six months, a long time. Although the Treasury department could hire experts to estimate their prices by methods like discounted cash flow, these estimates would be educated guesses with considerable margin for error.

The pricing challenge is politically explosive. If Treasury pays too much for these assets, Congress and taxpayers will protest. If the prices offered by the Treasury are too low, the banks won't sell.

Here's a practical solution: After making its best estimate of an asset's current value, Treasury should offer the bank a cash payment equal to 80% of that value. For the remaining 20%, Treasury should provide the bank with a capital certificate, which would count as common stock in determining whether the bank meets its capital requirement.

> The government and banks can share in any upside.

The certificate will also entitle the bank to 80% of the actual price at which the asset is later sold by the government—but only to the extent that the actual price exceeds the initial cash payment.

For example, suppose the Treasury estimates that a toxic asset is worth $700,000. It would pay the bank $560,000 in cash plus a capital certificate for $140,000.

If the government later sold that security for $660,000, the bank would receive an additional cash payment of $80,000 (80% of $100,000, the excess of $660,000 over $560,000). The Treasury would receive the remaining $20,000 of the excess.

On the other hand, if the government later sold the security for $550,000, the bank would receive nothing more. The Treasury would absorb a loss of $10,000.

This pricing plan should stimulate more lending by banks since they will immediately have cash on hand, instead of an illiquid toxic asset. Banks will also have the chance to receive more cash in the future if the toxic asset is sold at a price above the initial cash payment. In the interim, the capital certificate will help prevent the bank from becoming insolvent, since it will preserve the bank's capital for regulatory purposes.

The plan should also help banks sell new stock to institutional investors, instead of relying entirely on capital infusions from the Treasury. Institutional investors will not buy a bank's stock if they are worried that it will later announce large write-downs of its toxic assets. Now Treasury would effectively be setting a floor on the price of the asset equal to 80% of its estimated value.

Investors will rely on this floor in buying new stock from the bank. They will heavily discount the potential for payments on the subsequent sale of the asset.

Most importantly, the plan would be good for American citizens. They would benefit from more lending by banks, and more private investment in bank stocks instead of government capital infusions.

By limiting the initial cash payment to 80% of an asset's estimated value, the Treasury would be protecting taxpayers from overpaying in most cases. And the Treasury would periodically earn a commission for taxpayers by selling the toxic asset for more than its initial cash payment to the bank.

This plan would allow the government to remove toxic assets from the balance sheets of banks without having to nationalize or liquidate the banks. Under either of these alternatives, U.S. taxpayers would own all the toxic assets of these banks. Although the method of pricing proposed here is not perfect, it is better than these alternatives.

Mr. Pozen is chairman of MFS Investment Management.

THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL

TUESDAY, MARCH 10, 2009

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

The committee met, pursuant to notice, at 2:29 p.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, chairman of the committee, presiding.

Present: Senators Conrad, Murray, Wyden, Feingold, Stabenow, Cardin, Sanders, Whitehouse, Warner, Merkley, Gregg, Sessions, Graham, and Alexander.

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. First of all, I want to thank everybody for having this bit of a hiatus between when we had first scheduled the hearing and today and look forward to the opportunity to hear from the President's Budget Director.

I think we should remember what President Obama is inheriting: Record deficits, a doubling of the national debt in the previous 8 years, the worst recession since the Great Depression, financial market and housing crises unparalleled since the 1930's, 3.3 million jobs lost in the last 6 months, and ongoing wars in Iraq and Afghanistan. I tried to put myself in the shoes of the President and think what he must feel day after day when confronting these various crises. It must truly be daunting.

What President Obama Is Inheriting

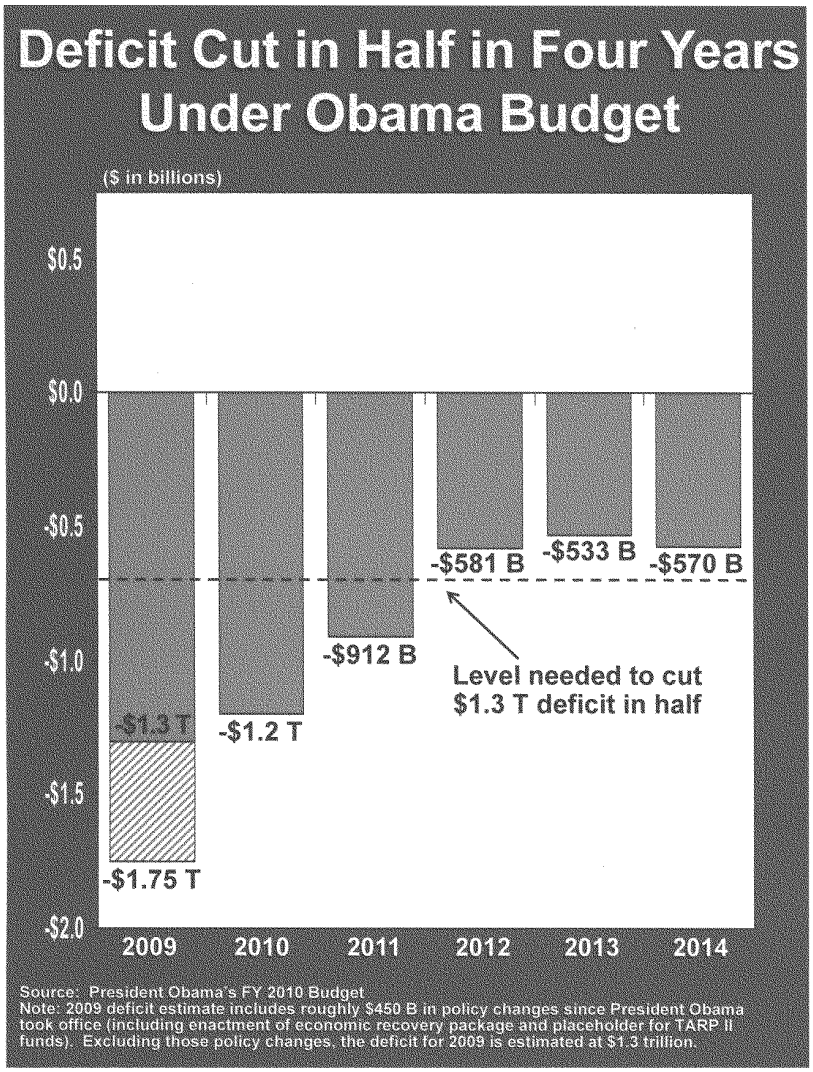
- Record deficits, doubling of national debt
- Worst recession since Great Depression
- Financial market and housing crises
- 3.3 million jobs lost in last six months
- Ongoing wars in Iraq and Afghanistan

With that, the Obama budget has a number of, I think, key improvements, more transparency, accounting for war costs previously unaccounted for, some important priorities, especially in energy and education and health care, and cutting the deficit in half, albeit from these very high levels as a result of the economic downturn.

Obama Budget Has Key Improvements Over Bush Budgets

- More transparency, accounts for war costs
- Better priorities – key investments in energy, education, health care
- Cuts deficit in half

This next chart shows the path of the deficit over the first 5 years of the President's budget, and you can see it more than cuts the deficit in half from its peak of this year.



The President has also committed to paying for health reform. He said this at the White House Health Summit on March 5: "We have also set aside in our budget a health care reserve fund to finance comprehensive reform. I know that more will be required, but this is a significant downpayment that's fully paid for and does not add one penny to the deficit."

President Obama Committed to Paying for Cost of Health Reform

"We've also set aside in our budget a health care reserve fund to finance comprehensive reform. I know that more will be required, but this is a significant down payment that's fully paid for, does not add one penny to our deficit."

–President Barack Obama
Remarks at White House Health Summit
March 5, 2009

Let me go to the next slide, if I can, with respect to the question of whether this budget is tax increases or tax cuts, because it depends very much what you have as the starting point. The Congressional Budget Office, which we follow, will use as its starting point the budget baseline based on current law. Looking at it from that perspective, they will say that this budget has more than a $2 trillion tax cut. They will get to that result by looking at the extension of the 2001 and 2003 tax cuts for those earning under $250,000 a year and they will score that as a $2 trillion tax cut.

Revenue Changes in Obama Budget

Extend 2001 and 2003 tax cuts for those under $250,000	-$2.0 T
Making Work Pay / other provisions for individuals, businesses	-$940 B
AMT relief	-$576 B
Cap and Trade	$646 B
Loophole closures, international reforms	$353 B
Limit itemized deductions (not in budget totals)	$318 B
Total Tax Cuts	-$2.2 T

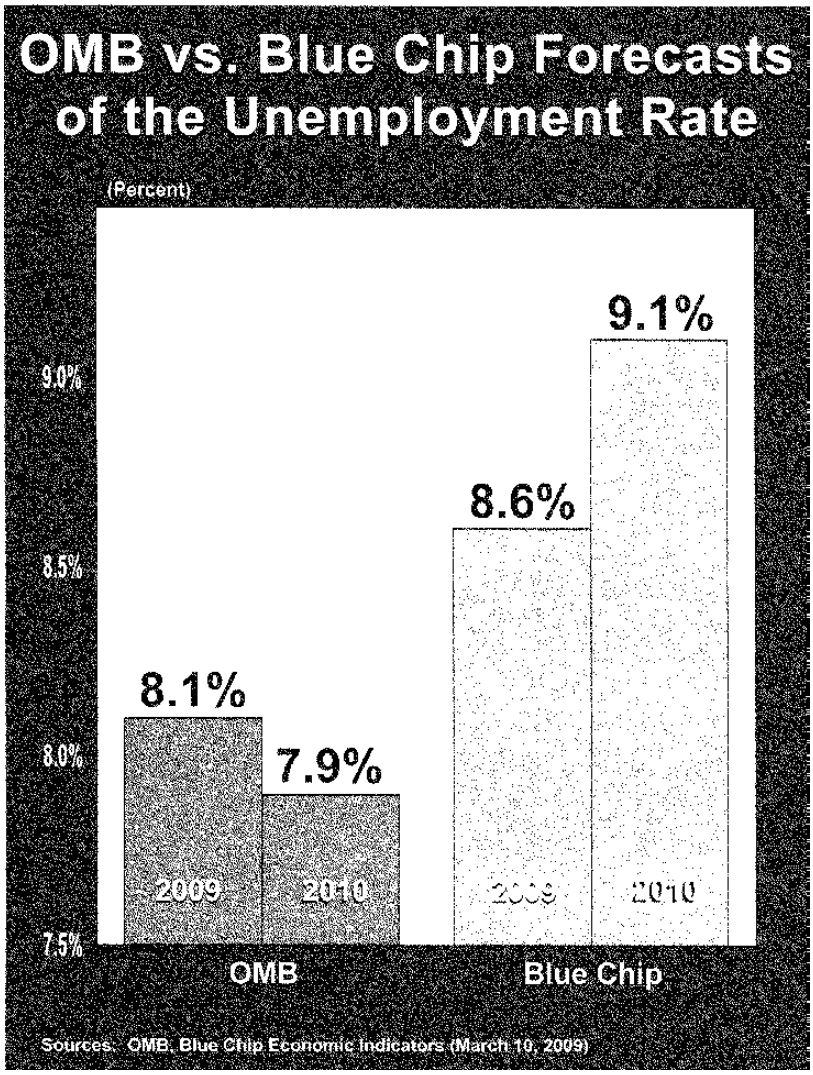
Source: OMB
Note: Revenue totals include outlays associated with refundable tax provisions.

Other provisions in the President's budget, including Making Work Pay and other tax incentives for individuals and businesses

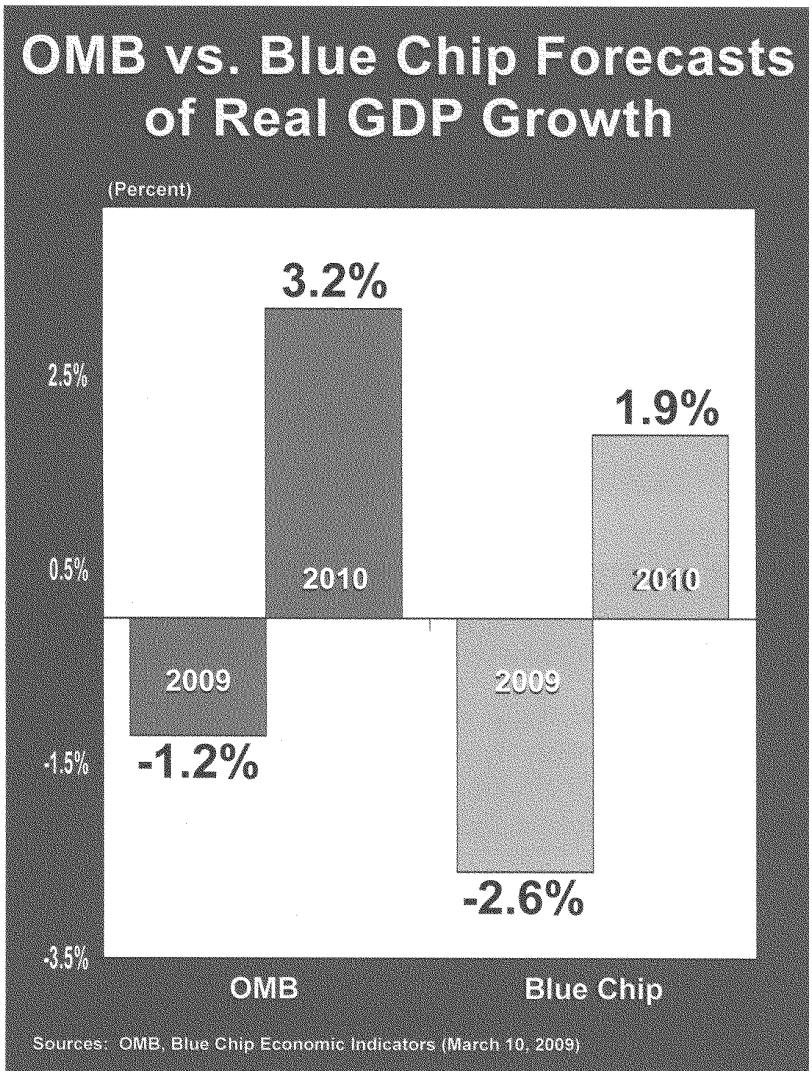
will account for another $940 billion of tax reduction. The Alternative Minimum Tax relief contained in the President's proposal will score at roughly $576 billion of tax relief.

On the other side of the ledger will be the cap and trade proposal, costing some $646 billion, various loophole closures and international reforms, raising $353 billion, and then the limitation on the itemized deduction, raising $318 billion. And you net it all out and CBO would say there is a tax reduction here of over $2 trillion.

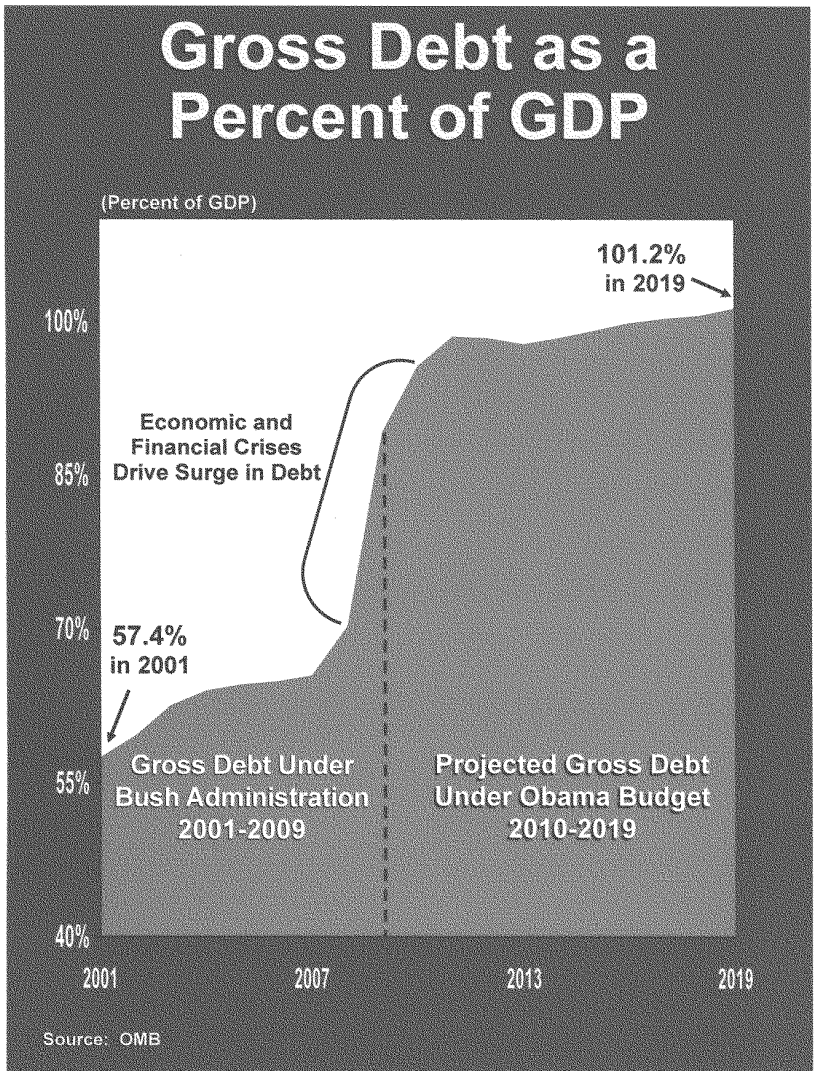
One of the issues that we are going to want to discuss today is the question of forecasts and the economics behind the forecast. Looking at OMB's forecasts of the unemployment rate, for example, comparing it to the blue chip for 2009 and 2010, for 2009 OMB is forecasting an unemployment rate of 8.1 percent, the blue chip forecasters 8.6 percent, and for 2010, OMB is forecasting 7.9 percent rate of unemployment, the blue chip forecasters 9.1 percent. There is obviously a question of how much of the stimulus is included in the blue chip forecast. We know it is included in the OMB forecast. Because of the way the blue chip forecasts are made, I don't think we can know for certain because it is an aggregation of forecasts of individual forecasters. Some have no doubt included the stimulus, others perhaps not.



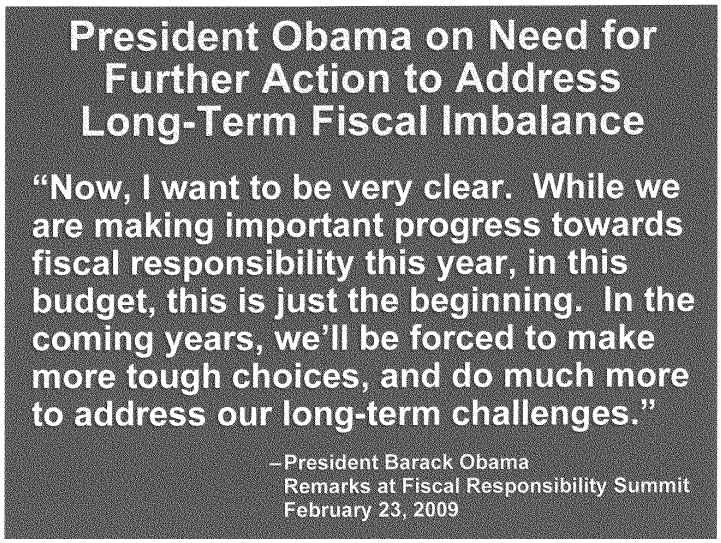
With respect to real Gross Domestic Product growth, or GDP growth, OMB is forecasting a contracting economy of 1.2 percent in 2009, the blue chip somewhat more pessimistic at 2.6 percent. And then in 2010, OMB is forecasting 3.2 percent and the blue chip 1.9 percent.



Next, looking at the gross debt as a percentage of GDP, we can see that gross debt is jumping very dramatically in this period, ending 2007, 2008, 2009, 2010, a very dramatic increase, which you would expect as a result of the steep economic decline. And then a flattening out through 2019 at about 101 percent of GDP. This is the area which is of significant concern to some of us. I would give the President pretty high marks on his budget the first 5 years, especially given these incredibly difficult times. My greatest concern is the second 5 years and what can we do to bend this debt curve, because I am concerned it is an unsustainable level of debt.



Finally, the President has said that same thing. At the Fiscal Responsibility Summit on February 23, he said, and I quote, "I want to be very clear. While we are making important progress toward fiscal responsibility this year in this budget, this is just the beginning. In the coming years, we will be forced to make more tough choices and do much more to address our long-term challenges." I agree entirely with that sentiment and hopefully we will hear more from the Budget Director on what the President intends to do to address those longer-term aspirations.



With that, I want to again welcome Dr. Orszag to the committee as the head of the President's Office of Management and Budget. We worked very well with him in his previous position as Director of the Congressional Budget Office. We are sorry to lose him from that position of responsibility, but we are delighted that the President is fortunate to have his good counsel.

Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman. I am glad to see you back. I hope you are feeling well, and it is good to see you have recovered, and it is nice to have Dr. Orszag here.

Obviously, we have some different views on this budget, but we do have some things we agree on. I appreciate the Chairman saying that in the second 5 years of this budget, the debt levels are unsustainable, because they are, and the cost of this budget is unsustainable and the tax burden is unsustainable. The Chairman didn't say that. I added the second two categories. The budget, on balance, spends too much, taxes too much, and borrows too much. It is that simple.

We do not argue—I do not argue, at least—with the fact that we are in a severe economic downturn. We all know that, and people's jobs are at risk and people are worried about tomorrow, paying the bills for tomorrow and there is great angst, and rightly so, and many people suffering hard times, and therefore the government has had to step up with a massive injection, historic injection of liquidity to try to move the markets and move the economy forward, and that has cost money in the short-run and we accept that.

The problem is that that effort to try to stabilize the economy has been used as a straw dog for the purposes of expanding the size of the government in the out years exponentially, moving it to the left in a way that has never been projected or seen before, should it be successful.

The budget proposes about $1.4 trillion in next taxes over the next 10 years, about $725 billion in new discretionary spending, about $1.2 trillion in new mandatory spending, and virtually no savings.

The practical implications of that is that unlike during the years of President Clinton's first term in office, when he proposed a major tax increase, as this budget does, and I think it is a bit of Wizard-of-Oz politics to claim there isn't a major tax increase in this bill, because there is and the people who are going to pay the national sales tax on their energy bills are going to feel it, and the people who are going to pay a 42 percent effective rate on their income are going to feel it, small business people especially, but he used those revenues for the most part to reduce the deficit in conjunction with a Republican Congress at the time that pushed the government in that direction. This massive expansion in revenues, however, is going to be used to massively expand the size of the government.

It doubles the national debt in 5 years, publicly held debt, this budget, and as the Chairman has said, some of that is understandable because of the fact that we have got this severe situation and a lot of debt is being run up as a result of that. But remember, much of the debt that is being run up in the short term, if it works, if the spending works, for example, the TARP works and some of the other initiatives work, is actually going to come back to us because it is invested funds. But the assumption is that it isn't going to come back to us to be used to reduce the debt. It is going to come back and be spent, all these funds coming back to us. So the debt triples in 10 years.

The practical implications of that are staggering for our children. We have seen this chart before. All the Presidents, including George Bush, since the beginning of our republic will not have run up as much debt as this budget will run up in the first period of its term.

The wall of debt, which has been a famous wall around here for a long time, jumps astronomically due to——

Chairman CONRAD. Do I get any kind of credit for these?

[Laughter.]

Senator GREGG. Credited to the Chairman. But the point here is this, that this debt, this increases the deficit as a percent. Do we have the next one, which shows the debt? I don't think we have it.

But this debt in the year 2013 creates a ratio of debt-to-GDP of about 67 percent. Historically, we have been around 40 percent. When you get up around 67 percent, as many of our witnesses have said in this committee, you are creating a situation which is probably untenable for our children because of the size of that debt, and the deficit maintains itself at approximately 3 percent to 4 percent of GDP for as far as the eye can see under this budget. And there is no factoring in, really, of what is coming at us in a significant way, which is the retirement of the baby boom generation that costs entitlements on top of all that.

So you essentially have set up a scenario here under this budget where we will pass on to our children in the very near future, at about the end of 4 years from now, a debt-to-GDP ratio which is unsustainable and a deficit ratio which is unsustainable. That

means our kids are going to have a hard time digging themselves out of this hole.

And I guess our debate with this budget goes to that point. Rather than doing something in the fourth, fifth, sixth year to bring those lines down and bend the debt down as a percent of Gross National Product and significantly bend down the deficits as a percent of Gross National Product, this idea that, well, they cut the deficit in half, well, if you quadruple the size of the deficit and then you cut it in half, what you have done is you have taken four steps back and two steps forward. You are still not going forward, and that is exactly what this does.

Rather than bending these numbers down so that we don't end up passing on to our kids a government that is not only unsustainable and unaffordable but a debt burden which is going to basically limit their capacity to have a high-quality life, what we are really doing here is giving them a government that is not sustainable or affordable.

And you look at the expansion of this government as proposed in the budget and it is really extraordinary. I mean, they are talking—the proposal here is to expand in health care and put in place $636 billion in new spending, and that is defined as a downpayment—a downpayment. That is not even considered to be the full payment. So let us say it is over $1 trillion of new health care spending. That is in an economy that already uses 17 percent of its Gross National Product on health care, which is about 5 percent higher than the next closest industrialized nation. It isn't that we don't have enough money in health care in this country in the system, it is that we don't use it effectively. But what this budget proposes is to expand the amount of money into health care geometrically, probably in the anticipation of some sort of nationalization of the system.

The same is done in education, where the entire education accounts in the student loan area is formally nationalized under the proposals.

So you take this government and you basically explode it in size and proportions, both in the tax burden and on the spending side of the ledger, while not doing anything—there is no significant effort in this proposal to address what is the looming fear that I am concerned about, which is the explosion in entitlement costs. No entitlement restraint in here of any significance over the long run.

And so we end up with a situation where what we are seeing here is a budget that is not sustainable for our nation, which fulfills maybe the desires and want of this administration in the area of spending, which it expands dramatically, and taxes, which it expands dramatically, but it doesn't address the issue of our kids' concerns because it expands the debt dramatically.

And again, this is all done under fairly rosy scenarios. I would say this is on the Tinkerbell side of rosy scenarios, this budget. Look at these numbers here as reflected by the blue chip estimates. The budget is making some assumptions which are very much a reach—8.1 percent unemployment when we are already at potentially 8.2 percent unemployment, growth rates which are much higher than anticipated by the blue chips, and tax revenues which are much higher than anticipated by the blue chips.

So the budget sets up some very significant problems for us as a nation, I believe, as we go forward, and it is appropriate that we address them.

Now, there are places where we could cooperate to get some things done around here that would actually bend these numbers in the out years, and yet we are not doing that. In the entitlement accounts, the Republican Leader has said on numerous occasions that he is willing to move forward in an aggressive attempt to try to bring under control the cost of Social Security as we head into the out years, or at least its burden on our children. The same is true in health care. There are other places where there could be cooperation.

I respect the administration putting forward, for example, ideas in the area of agriculture, limiting agricultural subsidies. But as a practical matter, the fundamental philosophy of this budget is an expansion of the size of government which isn't affordable by its own definition, because it maintains debt at a level which will essentially run our country into a position where our children cannot afford the cost of the government.

Thank you, Mr. Chairman.

Chairman CONRAD. Director Orszag, welcome. It is your turn.

STATEMENT OF HON. PETER R. ORSZAG, DIRECTOR, U.S. OFFICE OF MANAGEMENT AND BUDGET

Mr. ORSZAG. Thank you very much, Mr. Chairman——

Chairman CONRAD. Welcome back.

Mr. ORSZAG. —Ranking Member Gregg, members of the committee. Thank you for having me.

I am going to be brief, but let me try to address some of the things that were discussed in the opening statements.

I think we face a key choice. We can continue a path in which the theory of the case is that the top marginal tax rate drives economic performance above and beyond any other variable and in which market competition is defined by how many—how much subsidies you can provide to private firms, or we can change course, be honest about the fiscal condition that we are facing, invest in education, energy, and health care, which, by the way, corporate leaders have long identified as being key to our long-term economic performance and bringing the budget deficit down.

This budget includes $2.7 trillion in costs that have been excluded from previous budgets. For example, previous budgets have tended to assume that there would never again be a hurricane, that the Alternative Minimum Tax would take over the tax code, that physician payments would be reduced by 20 percent and yet Medicare beneficiaries would still somehow have access to their doctors. This budget does not play those games. It presents an honest depiction of the fiscal course that we are on and what we can do about it.

Now, there has been controversy about the economic assumptions. Let me speak to that directly. When the assumptions were locked down, they were fully in line with the Congressional Budget Office economic projections once the Recovery Act was included in the analysis. Since that time, incoming data have suggested a worse economic situation inherited by this administration than was

thought even at the time when the projections were locked down. I don't think it is constructive to be constantly chasing our tail, revising assumptions with each new piece of information, especially when we have not yet let the Recovery Act—we haven't given it the opportunity to work. The money is just beginning to flow. Let us see what happens.

But as an example, if you take those blue chip numbers that you put up, Mr. Chairman, and undertake the analysis of what that would do to the budget deficit relative to the projections that we use, the answer is that they would raise the budget deficit by under 5 percent for this year. So while there would be an impact, I think the argument that it dramatically changes the picture, given that we were already assuming substantial slowing of the economy and a substantial contraction this year, is exaggerated.

Second——

Chairman CONRAD. Is that 5 percent on a $1.8 trillion deficit?

Mr. ORSZAG. So roughly $50 billion or so, yes.

Second, with regard to whether this is a big spending budget, let us look at the actual data. For non-defense discretionary spending in 2009 as a share of the economy, discretionary spending outside of defense will be 4.1 percent of the economy. Under this budget, it averages 3.6 percent, and by the end of the projection window, 3.1 percent, the lowest on record since 1962 and one percent of GDP lower than where we are starting.

With regard to mandatory spending, there is some increase that occurs, but that is almost entirely because of the baseline, that is because of rising costs associated with an aging population. So, for example, under the baseline, between 2012 and 2019, mandatory spending goes from 11.9 percent of the economy to 13.2. Under this budget, it goes to 13.4, and that reflects, in our opinion, needed investments in education and other areas that have been neglected. Point-two percent of GDP is not an explosion in government spending, especially when non-defense discretionary spending declines by much more than that.

Third, with regard to entitlement spending, I think I have appeared before this committee over and over again and put up this chart, which actually comes from the Congressional Budget Office, and I think just looking at it makes the case that our entitlement problem is disproportionately focused in Medicare and Medicaid. Tackling health care reform is the key thing—you could think it is almost obvious from this graph—the key step in addressing our long-term fiscal problem. There are other issues that need to be addressed, Social Security and the rest of the budget. We do face a long-term deficit in Social Security and that will need to be addressed.

But if you look at this chart, I think it is pretty clear that a disproportionate share of the long-term fiscal problem occurs in health care. That is why we want health care reform done this year in a way that will reduce costs and improve quality. The $634 billion that we put on the table is not a net expansion in overall health care spending. In fact, half of it comes from reductions in Medicare and Medicaid spending under current law, including $177 billion in payments that are made to Medicare Advantage Plans above and beyond what they would receive under a competitive process. Medi-

care Advantage Plans, which are private insurance plans that cover beneficiaries under Medicare, are paid $1,000 more per beneficiary than covering the same beneficiary under traditional Medicare. We propose changing the system so that they competitively bid for the business of Medicare beneficiaries. I think that is a very pro-market and pro-competition step. It saves $177 billion.

Mr. Chairman, you had asked what the next steps were coming out of the Fiscal Responsibility Summit, and as the President mentioned at the end of that summit, we were—and, in fact, I believe this went out earlier this week or at the end of last week, but my understanding is that the comments that were made at the responsibility summit have now been circulated for revision and editing. We will get that back. We are going to then put that entire document out to the public within 30 days, as the President said, and we look forward to working with you on not only the process forward, but also the specific policy steps that could buildupon, I think what was a terrific summit where different perspectives were brought together, which is exactly what needs to happen.

So in summary, I just want to come back and say I do think we face a key choice. We have neglected for too long investments in education, in energy, and in health care. We have played budget gimmicks where we have hidden massive amounts of spending that was likely to occur, reflected in the $2.7 trillion that we are including in this budget that would have been excluded from previous budgets. And in particular, we have neglected for too long reforming our health care system and putting it on a sounder track where there are substantial opportunities to improve its efficiency, which will also have major benefits not only for our long-term budget picture, but for State government and for workers, because take-home pay is already being reduced to a degree that is unnecessarily large and underappreciated.

And with that, I will turn it back to you, Mr. Chairman, and again just look forward to working with you and the rest of the committee on these key issues. Thank you.

[The prepared statement of Mr. Orszag follows:]

Testimony of Peter R. Orszag,
Director of the Office of Management and Budget
Before the Committee on the Budget, United States Senate
March 10, 2009

Chairman Conrad, Ranking Member Gregg, and Members of the Committee, thank you for giving me the opportunity to discuss the President's Fiscal Year 2010 Budget.

Executive Summary

My full written statement delves into the details, but before we turn to those specifics let me step back and provide a broader overview of where we stand and where we need to go.

When the President took office on January 20th of this year, his Administration inherited an economic crisis unlike any we have seen since the Great Depression. Over four million jobs were lost over the past 14 months, more than at any time since World War II. From December 2008 to February 2009 alone, nearly 2 million people lost their jobs. Manufacturing employment has hit a 60-year low. Our capital markets are virtually frozen, making it difficult for businesses to grow and for families to borrow money to afford a home or college education for their kids. Trillions of dollars in wealth have been wiped out, leaving many families with little or nothing as they approach their retirement years.

A central cause of this economic crisis has been a meltdown in our credit and capital markets—one fueled by years of inadequate oversight, insufficient disclosure, and excessive conflicts of interest among market gatekeepers. But the problems in our markets are not the only cause of the current crisis. The roots run deeper.

We have arrived at this point because of an era of profound irresponsibility—in which we threw fiscal caution to the wind and ran up trillions of dollars in debt… in which the tax code was used to exacerbate income and wealth disparities, not mitigate them… and in which we failed to confront the deep, systemic problems that over time have only become a larger drag on our economic growth—from the rising costs of health care to the state of our schools, from how we power our economy to our crumbling infrastructure.

The result is a pair of twin deficits, each in the range of $1 trillion per year. The first trillion dollar deficit is the gap between how much the economy has the potential to produce and how much it is actually producing each year. This output gap of roughly $1 trillion in 2009 would represent nearly 7 percent of the estimated potential output of the economy. This gap is why it was so necessary that Congress passed the American Recovery and Reinvestment Act, in order to start filling this hole, to put Americans back to work, and to jumpstart the economy.

The other trillion-dollar deficit is the budget deficits we are inheriting. Over the last eight years, our national debt nearly doubled. The record surplus that was inherited by the previous Administration turned into a post-war record budget deficit. So let's be clear: the Obama Administration was faced with a $1.3 trillion deficit when we walked in the door.

We project that the deficit for the current fiscal year, including the recovery and stability plans, will be $1.75 trillion, or 12.3 percent of GDP. Of that, $1.3 trillion, or 9.2 percent of GDP, was already in place when we assumed office.

The President is determined to cut this $1.3 trillion deficit by at least half in four years. This would bring the deficit down to $533 billion by fiscal year 2013. More importantly, it would reduce the deficit to about 3 percent of GDP.

The economic crisis we faced when taking office has made our fiscal situation, dramatically and quickly, much worse—raising the budget deficit we are inheriting by a total of about $2 trillion for this year and next year:

- The weak economy, by reducing revenue collected and expanding the budget's automatic stabilizers (such as unemployment insurance), expands the deficit by more than $600 billion.

- Because of problems in financial markets, the costs of stabilization may amount to $650 billion or more—including the placeholder should additional efforts prove necessary to address the crisis we have inherited.

- To combat the recession, we had to act—through the $787 billion Recovery Act—to jumpstart job creation and growth.

Without the change in policies contained in the President's Budget, deficits would be another $2 trillion bigger over the next decade—and we wouldn't have begun to make the investments in American-made, alternative energy; better education; and more efficient and higher quality health care that are crucial to long-term economic and fiscal sustainability.

Let me be clear: there are two paths that our country can take. We can continue the policies of the past—dig an even deeper fiscal hole and once more put off the critical investments needed for long-term economic growth. Or we can reduce the deficit by $2 trillion over the next decade, cut the deficit inherited by this Administration in half by the end of the President's first term, and make needed investments in clean energy, affordable health care, and world-class schools.

In his Budget, the President laid out his way forward for our nation.

It begins with presenting an honest budget—one that is straightforward with the American people about the fiscal challenges we face. That's why we include the likely future costs of the wars in Iraq and Afghanistan and other possible overseas military operations, the cost of fixing the AMT each year, and reimbursements to Medicare physicians. We offer a 10-year rather than a five-year look into our fiscal situation, and we budget for the possibility that there may be a hurricane, earthquake, flood, or other disaster sometime over the next decade.

This honesty comes at a cost—$2.7 trillion or more over 10 years on our bottom line. But it's critical to begin tackling our fiscal challenges.

With the scope of the problem recognized, the President's Budget reduces our medium-term deficits to a sustainable level through both spending restraint and rebalancing of our tax code. And it addresses health care, the key to our longer-term fiscal future.

Broadly speaking, the medium-term deficit reduction comes from responsibly winding down the war in Iraq and reforms to the defense acquisition and procurement system; restoring balance to the tax code by returning to the pre-2001 tax rates for families making more than a quarter of a million dollars a year (while giving 95 percent of working families a tax cut), closing loopholes, and eliminating subsidies to special interests; and improving the efficiency of government.

Contrary to the instant analysis of many pundits, the Budget entails substantial spending restraint. Unlike what's occurred in the past, we make sure that we pay for new initiatives. And the Budget reduces non-defense discretionary spending—that is, the spending appropriated each year outside of defense—to its lowest level as a share of GDP since data began to be collected in 1962.

Let me underscore this last point. The average level of non-defense discretionary spending between 1969 and 2008 was 3.8 percent of GDP. In 2009, such spending is estimated to represent 4.1 percent of GDP.

The President's Budget proposes a gradual reduction of this non-defense discretionary spending as a share of economy. Spending averages 3.6 percent of GDP over the next decade and declines to 3.1 percent by the end of the 10-year budget window.

Over the longer term, however, the single most important step we could take to put the nation back on a path to fiscal responsibility is to address rising health care costs. As I have said before, health care is the key to our fiscal future. We cannot afford inaction.

That's why in the Recovery Act the President began the process that will rein in health care costs with significant investments toward computerizing America's health care records, accelerating comparative effectiveness research, and scaling up prevention and wellness programs. All of these will help move us toward a health system with lower costs and higher quality.

In this Budget, the President builds on these investments with a major commitment of $634 billion over 10 years to serve as a down payment for comprehensive health care reform. This reserve fund is financed half through walking back (to Reagan Administration levels) the itemized tax deductions allowed for families with incomes more than a quarter of a million dollars, and roughly half through efficiencies and savings from Medicare and Medicaid.

We must act now to begin the process of bending the curve on health care costs, and over time, realizing substantial savings for our nation—and improvements in health care quality and outcomes.

Health care is just one of three critical areas that for too long have been neglected and are deserving of significant investment now in order to create economic growth in years to come.

The others are clean energy and education—and this Budget makes significant investments in both.

The Budget invests $15 billion a year to reduce our dependence on foreign oil and improve energy efficiency. It finances those investments, along with tax relief for consumers, through a market-based cap-and-trade system to reduce greenhouse gas emissions.

The Budget also makes important investments in our most precious resource—our people—through a major new commitment to early childhood education, scaling up innovative new programs in our schools, and in improving college access for all our children. We can save almost $50 billion over the next decade by ending inefficient subsidies for student loan lenders. The Budget would also invest in making college more accessible, by making the $2500 American Opportunity Tax Cut permanent, increasing the size of Pell Grants and putting the program on more solid footing, and simplifying the application process. These steps will help us reach the President's goal of having the United States lead the world in the proportion of college graduates by 2020.

Some may say that now is not the time to make these investments—that our fiscal and economic situation is too precarious. I share their concern about the fiscal health of our nation—and the President does as well. As he has said repeatedly, part of our long-term economic security is how we handle these deep, fiscal challenges—and we are already taking aggressive action to meet that challenge.

But the bottom line is that that we simply cannot afford to stay on the course that we've been on. If we do not begin to address the high costs of health care, our families will continue to be squeezed, our businesses will have trouble competing, and our nation will remain on an unsustainable fiscal path. If we do not invest in education and clean energy, our prospects for long-term economic growth will be diminished. And if we do not make government more efficient, we will continue to waste the precious resources we do have.

It'll take time to work through the challenges we have inherited—and change doesn't come easy. But as in most difficulties in life, we must adapt, adjust, and overcome. I am confident that if we confront our problems honestly and take responsibility for our future, our nation will rebuild, recover, and emerge stronger than ever.

A Pair of Trillion Dollar Inherited Deficits

I come before the Committee at a time of great peril for our economy and for our nation's fiscal future. The new Administration has inherited an economic crisis unlike any we have seen in our lifetimes. Our economy is in a deep recession, which threatens to be more severe than any since the Great Depression. More than four million jobs were lost over the past 14 months, more than at any time since World War II. In addition, approximately another 9 million Americans are under-employed. Manufacturing employment has hit a 60-year low. Our capital markets are virtually frozen, making it difficult for businesses to grow and for families to borrow money to afford a home, car, or college education for their kids. Trillions of dollars of wealth have been wiped out, leaving many workers with little or nothing as they approach retirement.

The result of this bleak economic picture, as well as the misplaced policy priorities of previous years, is a pair of twin deficits, each in the range of $1 trillion per year. The first trillion dollar deficit is the gap between how much the economy has the potential to produce and how much it is actually producing each year. This output gap of roughly $1 trillion in 2009 would represent nearly 7 percent of the estimated potential output of the economy. This gap is why it was so necessary that Congress passed the American Recovery and Reinvestment Act, to start filling this hole and jumpstart the economy through fiscal stimulus that increases short-term demand for goods and services.

Because fiscal stimulus boosts aggregate demand through increases in government spending or reductions in taxes, such policies raise budget deficits in the short term. That effect is desirable because it reflects the delivery of increased aggregate demand to the economy. Contemporaneous changes elsewhere in the Budget—tax increases or reductions in spending—designed to offset these short-term deficit effects would be counterproductive, because they would reduce or eliminate the stimulative effect. During an economic downturn, the key to economic growth is the demand for the goods and services the economy could produce with existing capacity—and in that situation, temporary increases in the deficit are necessary to put the economy back on track.

As the economy recovers, however, the effect of deficits on the economy reverses. At that point, the key to economic growth switches from boosting demand for goods and services (so existing capacity is fully used) to increasing the rate at which we expand the capacity for producing goods and services. Large budget deficits become harmful in this situation because they entail some combination of reduced funds available to finance domestic investment or increased borrowing from abroad to finance that domestic investment. Either way, budget deficits reduce future national income—either because the nation does not have as much productivity-enhancing capital in the future or because we owe larger liabilities to foreign creditors. In the extreme, sustained deficits could seriously harm the economy. Large deficits would also limit our maneuvering room to handle crises in the future.

This brings me to the second trillion dollar deficit that the new Administration is inheriting. Under current policies, we face fiscal deficits of almost $1 trillion a year on average over the coming decade. OMB projects that the baseline deficit for FY 2009 will be about $1.5 trillion, or 10.6 percent of GDP. Over the ten-year budget window, from FY 2010 to FY 2019, aggregate baseline budget deficits will total nearly $9.0 trillion and average almost 5 percent of GDP. Over longer periods of time, the deficit reaches even higher shares of GDP primarily because of rising health care costs.

Over the medium to long term, the nation is thus on an unsustainable fiscal course. We need to act, both to address the dramatic shortfall in national output in the near term and to tackle the medium- and long-term deficits that would ultimately become a drain on the nation's potential for economic growth. The Recovery Act that Congress passed a few weeks ago was a bold and important first step toward addressing the first of the twin deficits we inherited. I will spend the remainder of my time today talking about the Administration's plans, detailed in the President's

Budget, for dealing with the second of these inherited deficits, along with a few of the key investments the Budget would make in the nation's economic future.

Return to Honest Budgeting

The first step in addressing our nation's fiscal problems is to be honest about them. Too often in the past several years, budget tricks were used to make the government's books seem stronger than they actually were. If this Budget used the gimmicks employed in recent budgets, it would show a bottom line that would appear about $2.7 trillion better over ten years. Instead, the Budget acknowledges additional deficits of about $230 billion, or about 1.3 percent of GDP, in 2013 alone—deficits that previous budgets would have simply pretended didn't exist. Appearances can be deceiving, and omitting likely future costs is an accounting trick, not reality.

Unless we are straightforward about the scope and scale of our nation's medium- and long-term fiscal problems, we cannot hope to reach agreement on a plan for solving them. As a result, the President's Budget returns the nation to an honest budget footing by recognizing, rather than omitting, an array of future Federal government costs. Among these are:[1]

- **Including the likely future costs of overseas contingency operations**. Our Budget includes funding over ten years for overseas contingency operations, raising projected deficits by about $580 billion over the next ten years compared to the treatment in prior budgets. These prior budgets generally did not assume any funding for overseas contingency operations in the out-years. We include estimated costs of these operations in the out-years to be fiscally conservative, but they do not reflect any specific policy decisions. Several strategy reviews are underway that will inform out-year costs, and it would be premature at this time to prejudge those reviews.

- **Indexing fully the alternative minimum tax for inflation rather than assuming that AMT relief will suddenly expire**. Our Budget includes an AMT fix in all years, raising projected deficits by about $1.4 trillion over the coming decade. In contrast, past budgets have generally included AMT fixes for only the current year. Almost everyone agrees, however, that policymakers will not allow the AMT to take over the tax over time, and our Budget reflects that reality rather than pretending it does not exist.

- **Incorporating reimbursements to Medicare physicians, without assuming deep and sudden cuts in those payments.** Our Budget includes the Administration's best estimate of future SGR relief given the agreed-to fixes for Medicare physician reimbursement in past years. As a result, projected deficits are about $400 billion higher over the next ten years than they would otherwise be. In contrast, past budgets accounted for no SGR relief in any years. (Although our Budget baseline reflects our best estimate of future SGR relief given past policy actions on SGR, as discussed below we are not asserting that this should be the future policy and we recognize that we need to move toward a system

[1] The following cost estimates include interest expenditures; in addition, the estimate for the AMT policy assumes extension of the 2001 and 2003 tax cuts.

in which doctors face stronger incentives for providing high-quality care rather than simply more care.)

- **Recognizing the statistical likelihood of Federal costs for natural disasters instead of assuming that there will be no such costs**. Our Budget accounts for the statistical probability of Federal government costs for future disasters, raising our projected deficits by more than $270 billion over the coming decade. Recent budgets generally did not assume that there would be such costs over the budget window.

- **Offering a ten-year rather than five-year look into our fiscal situation**. Our Budget uses a ten-year budget window. With the baby boom generation moving into retirement, slowly at first but more rapidly as the years pass, the costs of Medicare and Social Security will increase with time. For that reason, a ten-year view of the budget gives a better sense of the effect of the budget on the long-term fiscal picture than a five-year view. Recent budgets employed only a five-year budget window.

The Long-Term Fiscal Gap and Health Care

The principal driver of our nation's long-term budget problem is rising health care costs. If costs per enrollee in our two main Federal health care programs, Medicare and Medicaid, grow at the same rate as they have for the past 40 years, those two programs will increase from about 5 percent of GDP today to about 20 percent by 2050. (As the Congressional Budget Office (CBO) and others have noted, there are reasons to expect cost growth to slow in the future relative to the past even in the absence of policy changes. But the point remains that reasonable projections of health care cost growth under current policies shows that they are the central cause of the nation's long-term fiscal imbalance.) Many of the other factors that will play a role in determining future fiscal conditions—including the actuarial deficit in Social Security—pale by comparison over the long term with the impact of cost growth in Federal health insurance programs. Health care is the key to our nation's fiscal future, and health care reform is entitlement reform.

The Administration has signaled its understanding of health care's centrality to our nation's fiscal future through its actions in its first weeks and through the submission of this Budget. Two weeks ago, the President signed the American Recovery and Reinvestment Act, which devotes resources now to develop the infrastructure for lowering health spending in the long run, including key investments in computerizing medical records, comparative effectiveness research, and prevention and wellness interventions.

To build on these steps, the President's Budget sets aside a reserve fund of more than $630 billion over 10 years dedicated to financing reforms to the American health care system. While a very large amount of money and a major commitment, the Administration recognizes that $630 billion is not sufficient to fully fund comprehensive reform. But this is a first crucial step in that effort, and we are committed to working with Congress to find additional resources to devote to health care reform. The Administration will explore all serious ideas that, in a fiscally responsible manner, achieve the common goals of constraining costs, expanding access, and improving quality.

Although reforming health care is the key to our nation's fiscal future, other programs – including Social Security – do contribute to our long-term deficit. The long-term shortfall in Social Security, though, is modest relative to the possible effect of health care on the budget. As I just mentioned, if costs per enrollee in Medicare and Medicaid, grow at the same rate as they have in the last four decades, the costs associated with these two programs would increase by 15 percentage points of GDP—rising from 5 percent of GDP today to about 20 percent by 2050. By comparison, the cost of Social Security benefits is expected to increase by 1.5 percentage points of GDP over this same period, according to the Social Security actuaries, and the system, without any changes, is expected to be able to pay full benefits through 2041. After we reform health care, the Administration looks forward to working with Congress to strengthen Social Security's finances.

Health Care Reserve Fund

The $630 billion reserve fund is financed roughly 50-50 between a combination of re-balancing the tax code so that the wealthiest pay more and specific health care savings in three areas: promoting efficiency and accountability, aligning incentives toward quality, and encouraging shared responsibility.

Lowering health care costs and expanding health insurance coverage will require additional revenue. The Budget includes a proposal to limit the tax rate at which high-income taxpayers can take itemized deductions to 28 percent. The initial reserve fund would be about half funded through this provision, which would raise $318 billion over 10 years. In the health reform policy discussions that have taken place over the past few years, a wide range of other revenue options have been discussed—and these options are all worthy of serious discussion as the Administration works with Congress to enact health care reform.

On the savings side, the Budget proposes health savings for the reserve fund that would total $316 billion over 10 years, which would simultaneously help to improve the quality and efficiency of health care without negatively affecting the care Americans receive. These savings include:

- **Reducing Medicare overpayments to private insurers through competitive payments.** Under current law, Medicare pays Medicare Advantage plans 14 percent more on average than what Medicare spends for beneficiaries enrolled in the traditional fee-for-service program. This is because the current system bases payments on administratively determined benchmarks that are set well above the cost of providing fee-for-service Medicare benefits. Medicare pays roughly $1,000 per beneficiary more each year as a result, and MedPAC estimates that the Federal government pays $1.30 for each $1.00 increase in Medicare Advantage supplementary benefits. Even with these subsidies, the evidence suggests that Medicare Advantage does not provide better quality of care.

  The Budget would replace the current mechanism used to establish payments with a new competitive system in which payments would be based upon an average of plans' bids

submitted to Medicare. The Administration's proposal would better align plan payments with the actual cost of coverage. This would allow the market, not Medicare, to set the reimbursement limits. This is similar to the process used for establishing payments for the Medicare Part D drug benefit. Our proposal would save taxpayers more than $175 billion over 10 years as well as reduce Part B premiums.

- **Reducing drug prices.** The Budget would accelerate access to affordable generic biologic drugs through the establishment of a workable regulatory, scientific, and legal pathway for generic versions of biologic drugs. To retain incentives for the research and development of breakthrough products, a period of exclusivity would be guaranteed for the original innovator product, which is generally consistent with the principles in the Hatch-Waxman law for traditional products. Brand biologic manufacturers would also be prohibited from reformulating existing products into new products to restart the exclusivity process, a process known as ever-greening. Furthermore, the Administration would prevent drug companies from blocking generic drugs from consumers by prohibiting anticompetitive agreements and collusion between brand name and generic drug manufacturers intended to keep generic drugs off the market.

  In addition, the Budget would bring down the drug costs of Medicaid by increasing the Medicaid drug rebate for brand-name drugs from 15.1 percent to 22.1 percent of the Average Manufacturer Price, applying the additional rebate to new drug formulations, and allowing states to collect rebates on drugs provided through Medicaid managed care organizations.

- **Improving Medicare and Medicaid payment accuracy.** The Government Accountability Office (GAO) has labeled Medicare as "high-risk" due to the billions of dollars lost to overpayments and fraud each year. The Budget proposes $311 million in FY 2010 for program integrity activities for the Centers for Medicare and Medicaid Services (CMS) initially targeted to remedy the vulnerabilities in Medicare and Medicaid, including Medicare Advantage (MA) and the prescription drug benefit (Part D). CMS will be able to respond more rapidly to emerging program integrity vulnerabilities across these programs through an increased capacity to identify excessive payments and new processes for identifying and correcting problems. With this additional funding, CMS will be better able to minimize inappropriate payments, close loopholes, and provide better value for program expenditures to beneficiaries and taxpayers.

- **Improving care after hospitalizations and reducing hospital readmission rates.** Nearly 18 percent of hospitalizations of Medicare beneficiaries result in the readmission of patients who have been discharged from the hospital within the last 30 days. Sometimes such readmissions cannot be prevented, but many are avoidable. Under the policy in the Budget, hospitals would receive bundled payments that cover not just hospitalization, but care from certain post-acute providers for the 30 days after hospitalization, and hospitals with high rates of readmission would be paid less if patients are re-admitted to the hospital within that 30-day period. This combination of incentives and penalties should lead to better care after a hospital stay and result in fewer readmissions—saving roughly $26 billion of wasted money over 10 years.

- **Expanding the Hospital Quality Improvement Program.** The health care system tends to pay for the quantity of services delivered, not their quality. Experts have recommended that hospitals and doctors be paid based on delivering high quality care, or what is called "pay for performance." The Budget proposes to link a portion of Medicare payments for acute inpatient hospital services to hospitals' performance on specific quality measures. This program would improve the quality of care delivered to Medicare beneficiaries and is estimated to save more than $12 billion over 10 years.

Long-Term Containment of Health Care Costs

By identifying specific health savings for the health care reserve fund, the Administration is making a down payment on expanding health care coverage to all Americans and also on containing the growth in health care costs required to restore long-run balance to the nation's fiscal outlook.

Yet there are additional steps that can be taken to address the fundamental inefficiencies of our nation's health care system. Across the country, health care costs vary substantially from region to region, and yet higher-cost areas do not generate better health outcomes than lower-cost areas. Even among our nation's leading medical centers, costs vary significantly—with costs at some centers twice as high as others—but higher-cost centers do not achieve higher quality than lower-cost centers. Some researchers believe health care costs could be reduced by a stunning 30 percent—or about $700 billion a year—without harming quality if we moved as a nation toward the proven and successful practices adopted by lower-cost areas and hospitals.

Capturing this opportunity would help to boost family take-home pay and put the nation on a sounder fiscal path. It will require expanding the use of health information technology, more aggressively studying what works and what doesn't, promoting prevention and healthy living, and experimenting with different payment systems to health care providers.

The Administration is committed to bringing about these reforms in order to slow health-care cost growth over the long run and has already initiated many of them through the Recovery Act, including computerizing America's health records in five years, developing and disseminating information on effective medical interventions, investing in prevention and wellness, and reforming the physician payment system to improve quality and efficiency.

Medium-Term Deficit Reduction

The health care reforms I have described will reduce the growth of health care costs over time, and thus address the most important contributor to the nation's long-term fiscal shortfall. These changes will take time, however. In the meanwhile, we also need to begin making the hard choices that will, as the economy recovers, reduce deficits in the medium term.

Without using the gimmicks of previous budget proposals, the Budget cuts in half, by the end of the President's first term, the deficit this Administration inherited when it took office. Over the next four years, the deficit would fall to about three percent of GDP under the Administration's

policies and remain stable through the remainder of the coming decade. The Budget reaches this path by proposing policies that pare back deficits by a total of $2.0 trillion over the next ten years. This brings us to a sustainable and realistic fiscal course for the coming decade.

The Budget features four main deficit reduction mechanisms:

- First, economic recovery, aided substantially by the Recovery Act, will help to reduce deficits by automatically dampening spending in safety net programs and raising revenues.

- Second, the Budget would return fairness to the tax system by closing tax loopholes, eliminating subsidies for special interests, enhancing enforcement, and returning to the pre-2001 tax rates for high-income families making more than $250,000 per year.

- Third, the Budget reflects savings from responsibly redeploying our military forces engaged in overseas contingency operations, as well as reforms that would allow us to get more for the money spent on defending the nation.

- Finally, the Budget includes significant spending constraints and puts the nation on a path to reducing non-defense discretionary spending as a share of GDP. The average level of NDD spending between 1969 and 2008 was 3.8 percent of GDP. In contrast, the President's Budget proposes a gradual reduction in NDD spending as a share of the economy. Such spending averages 3.6 percent of GDP from 2010 to 2019 and declines to 3.1 percent by the end of the budget window – the lowest since the government began collecting the data in 1962.

These measures facilitate some key investments in productivity-enhancing areas like education and infrastructure (discussed later in this testimony) while also producing a net deficit reduction of $2 trillion over the next decade.

I will now discuss a number of these sources of deficit reduction in greater detail.

Returning Fairness to the Tax System

The Budget returns fairness and balance to the tax system. While providing tax cuts to 95 percent of working families, the Budget raises additional revenue from the corporations and individuals most able to pay.

After year upon year of tax reductions that disproportionately benefited the wealthiest Americans, we have been left with a tax system that is insufficient to meet national needs. Under current policies, even after the economy recovers, revenue would be below its 1990s average—despite rising health care costs and other new burdens the government faces. After the end of the recession, the Budget therefore raises revenue to a level that, as a share of GDP, is still lower than in the latter half of the 1990s. The Budget includes the following revenue proposals:

- **Allowing the 2001 and 2003 tax cuts to expire for high-income Americans.** The Budget proposes allowing most of the 2001 and 2003 tax cuts to expire in 2011, as scheduled, for couples making more than $250,000 and individuals making more than $200,000 per year. Additional revenues gained would be devoted to deficit reduction. These tax cuts were both unaffordable and unfair at the time they were enacted, and remain so today. This Budget would simply return the marginal tax rates for these wealthiest Americans to what they were prior to 2001. Altogether, allowing these tax cuts to expire would reduce the deficit by about $750 billion over the next ten years relative to current policy.

- **Eliminating tax subsidies for corporations and high-income individuals.** The current tax system is undermined by subsidies that benefit only narrow and often well-heeled interest groups. The President's Budget would eliminate a range of such subsidies. The Budget proposes to do away with tax subsidies for oil and gas companies described further below and to no longer allow the managers of private equity and other partnerships to enjoy a low capital gains rate on part of their labor income—instead, treating their compensation like other forms of compensation. Further, the Budget lays the groundwork for reforming our tax code so multinational corporations pay taxes more like domestic companies, rather than being able to defer taxation of profits earned by their subsidiaries.

- **Closing tax loopholes for oil and gas companies.** The Budget proposes the elimination, starting in 2011, of an array of tax advantages for domestic oil and gas producers. Although the Administration supports the responsible production of oil and natural gas as part of a comprehensive energy strategy, excessive government subsidies distort market signals and slow the transition of the economy from fossil fuels to clean, renewable sources of energy. (To take just one example, the Administration proposes to repeal the expensing of intangible drilling costs such as labor, chemicals, and grease. Under the existing provision, if $80,000 of a $100,000 investment in an oil well were spent on intangible drilling costs, that $80,000 could be immediately written off by a producer, rather than amortized over the life of the asset, as would be the rule for the costs of labor and materials used to build a factory, for example.)

- **Enhancing enforcement.** According to the latest estimate, the net tax gap—the gap between what corporations and individuals owe under the tax law and what they paid either voluntarily or as a result of enforcement actions—stands at nearly 3 percent of GDP. To give a sense for the magnitude of this number: This is nearly five times what the Federal government spends each year on veterans and about equal to what it currently spends on Medicare. We can and must do better than this.

  This Budget proposes measures that would enhance enforcement, making more corporations and individuals pay the taxes they already owe under current law. For instance, the Budget would attack sham tax transactions by codifying the principle that corporations and individuals cannot avoid paying taxes by engaging in transactions for no other reason than to lower their tax liability. It would also require increased reporting of rental payments to the IRS so this income is properly reported by the recipient.

Furthermore, the Budget proposes targeting tax havens and expanding international tax enforcement efforts—efforts that, while still in the planning stages, are expected to raise considerable revenues over time.

Redeploying Military Forces Engaged in Overseas Contingency Operations and Restraining Growth of Other Defense Spending

As we look to the challenges facing our nation, it is imperative that we invest our defense dollars effectively and wisely.

The Budget reflects savings from two sources in the defense budget:

- **Redeployment of military forces engaged in overseas contingency operations.** The Budget funds the Administration's strategy to increase our troop levels in Afghanistan and to responsibly remove combat brigades from Iraq. Under this strategy, the costs of operations in the two countries combined are expected to fall. Under the President's Budget, as troop levels decrease, the combined cost of Iraq and Afghanistan operations would decrease by about $50 billion in 2009 and $65 billion in 2010, compared with the 2008 level of $187 billion (adjusted for inflation). Beginning in 2011, the Budget reflects a placeholder cost of about $50 billion per year, which is included to be responsible but does not reflect any specific policy decisions. Several strategy reviews are underway that will inform out-year costs, and it would be premature at this time to prejudge those reviews.

- **Restraining growth of other defense spending while maintaining key priorities.** For FY 2010, the Budget requests $533.7 billion for the Department of Defense (DoD), an increase of $20.4 billion, or 4 percent, from the 2009 enacted level of $513.3 billion (excluding $7.4 billion from the Recovery Act). This growth is greater than the post-Cold War average of 2.9 percent but less than the nearly 7 percent annual growth over the last eight years.

  This level of growth maintains a strong Defense Department, allowing DoD to address the President's highest priorities. These priorities including increasing the size of the Army and Marine Corps, giving a 2.9 percent pay raise to our men and women in uniform, improving DoD facilities (especially military housing), and improving the medical treatment of wounded service members. Taking into account the importance of managing defense priorities in a cost-efficient manner, the Budget also emphasizes acquisition reform. The Administration will work to set realistic requirements and incorporate "best practices" to control the cost growth and schedule slippage of DoD's weapons programs.

Line-by-Line Review of the Budget

The Administration believes that we should be investing taxpayer dollars in efforts and programs with proven records of success and reallocating or eliminating programs that do not work or whose benefits are not worth their cost. To this end, the Administration has begun an exhaustive

line-by-line review of the Federal budget, starting with one of its most important lines—health care. The first stage of this line-by-line review will be reflected in the spring release of the full FY 2010 Budget and will continue in subsequent years. However, the Administration has already identified a number of policies to drive savings. These include:

- Increasing Federal government health savings, as specified earlier in my testimony.
- Phasing out and eliminating certain inefficient agriculture subsidies, such as direct payments to high-revenue crop producers and storage subsidies for cotton producers. These measures would cut deficits by about $19 billion over the next ten years.
- Eliminating subsidies to banks participating in the student loan program. As I discuss in greater detail later in my testimony, banks that make government-guaranteed loans are entitled to subsidies that are set by Congress. In the Budget, we propose to eliminate these subsidies while providing a more stable source of financing for student loans. This reduces deficits by another $60 billion over the next ten years.
- Reducing erroneous payments in Federal programs and increasing tax enforcement by investing in "program integrity." The Budget also makes significant investments in activities to ensure that taxpayer dollars are spent correctly, expanding oversight of the largest benefit programs and increasing investments in tax compliance. These efforts are expected to reduce deficits by about $64 billion over the coming decade.
- Targeting other inefficient or ineffective programs. The Budget not only focuses on "big dollar" initiatives. It also recognizes that, even if relatively small amounts of money are at stake compared to the scale of the Federal budget, taxpayers' funds should be used wisely. The Budget, for instance, proposes eliminating small, ineffective HUD programs and increasing collection of delinquent tax from Federal contractors.

This list gives a flavor of the program eliminations and investments in efficiency included in the Budget. We expect to propose further such measures as we move forward with our intensive review of Federal government programs.

Reforming How Government Works

The President's Budget also begins the process of reforming how government works, increasing efficiency, transparency, and simplicity. The initiatives both protect taxpayer dollars and, also, make it easier for the American people to interact with their government. This reform process is not one that can be completed overnight, and the Administration will continue to develop new ways to make government work better for the people. The Budget is a starting point and an important step forward.

Improve Administrative Performance

Reforming how government works is not only a question of cutting and eliminating ineffective programs, but also making worthwhile programs work better by improving performance. For decades, the argument in Washington has been between those who say that government is the cause of every problem and those who say it is the answer. What has become clear over the past eight years, especially in light of the Federal government's response to Hurricane Katrina, is that what really bothers Americans is bad government—government that does not do its job effectively and efficiently.

To make government more effective, the Administration will undertake a number of initiatives. These include:

- **Streamlining government procurement.** The Administration will implement the GAO's recommendations to reduce erroneous Federal payments, reduce procurement costs with purchase cards, and implement better management of surplus Federal property.

- **Reforming Federal contracting and acquisition.** The Administration will take several steps to make sure that taxpayers get the best deal possible for government expenditures. We will review the use of sole source, cost-type contracts; improve the quality of the acquisition workforce; and use technology to create transparency around contracting. We will review acquisition programs that are on the GAO high-risk list for being over-budget and prone to abuse. The Administration also will clarify what is inherently a governmental function and what is a commercial one; critical government functions will not be performed by the private sector.

- **Enforcing standards in addition to measuring performance.** The Administration will fundamentally reconfigure the Program Assessment Rating Tool (PART). We will engage the public, Congress, and outside experts in the development of an open performance measurement process that improves results and outcomes for Federal government programs while reducing waste and inefficiency. The Administration will develop goals Americans care about and that are based on congressional intent and feedback from the people served by government programs. Programs will not be measured in isolation, but assessed in the context of other programs that are serving the same population or meeting similar goals. I will ask each major agency to identify a limited set of high priority goals over the next few months that will serve as the basis for the President's meetings with cabinet officers to review their progress toward meeting performance improvement targets. We will also identify opportunities to engage the public, stakeholders, and Congress in this effort.

- **Improving program integrity.** With hundreds of billions of dollars being spent in programs such as Medicare, Medicaid, and Social Security, it is important that they are run efficiently and effectively. For every $1 spent to combat health care fraud, for example, evidence suggests that the government recoups $1.60. The Administration will expand oversight activities in our largest benefit programs -- so that the right payment is made to the right person or provider at the right time -- and increasing investments in tax

compliance and enforcement activities. We expect these investments to save a total of $48.5 billion over the next ten years in these areas.

- **Cutting the government's electricity bills.** The Federal government is the largest energy consumer in the world. Making substantial investments to reduce the government's energy consumption can spur job creation while delivering long-term government savings through lower energy bills. The Budget will build upon the more than $11 billion provided for building modernization in the Recovery Act to achieve the Administration's 25 percent energy efficiency improvement goal by 2013.

Education

While aiming to make government work better overall, the Budget also focuses its reforms on certain priority areas. When it comes to education policy, the Budget seeks to increase efficiency, simplicity, and transparency through a number of initiatives including:

- **Eliminating government-created subsidies for banks in the student loan program and shifting savings to students.** Right now, banks that make government-guaranteed loans are entitled to subsidies set through the political process. Because of turmoil in the financial markets, the bank-based program has needed additional government supports over the last year, and even so, lender instability has forced thousands of students to change lenders abruptly. Meanwhile, last year more than 800 schools enrolled in the direct loan program, and nearly half made direct loans last year, all without significant disruption. Student satisfaction with direct loans is high, while cost to taxpayers is low, because the program uses competitively selected, private providers to service loans. The Budget would originate all loans in the direct loan program beginning in the 2010-11 school year. Analysis by CBO, GAO, and OMB shows this approach would save taxpayers large sums of money; by our estimates, it would save more than $4 billion a year.

- **Making it easier to apply for student aid.** To apply for student aid, students must complete a complicated form. Our plan, while still in development, would considerably simplify the process through such measures as streamlining the form itself and/or using tax data to automatically populate the form with an applicant's answers. This is not merely a question of saving time, but also encouraging more eligible students to participate in the program.

- **Increasing transparency of the Pell program.** In addition to increasing the maximum Pell award to $5,550 for the 2010-11 school year, the President's Budget makes the program's funding more transparent by converting the program from a discretionary to a mandatory program. This would end the dishonest practice of "backfilling" billions of dollars in Pell shortfalls each year and provide certainty to families about the level of Pell Grant funding available each year.

- **Preparing and rewarding effective teachers and principals.** Building on the investments in the Recovery Act, the Administration will invest in efforts to strengthen

and increase transparency around results for teacher and principal preparation programs, including programs in schools of education, alternative certification programs, and teacher and principal residency programs. The Budget supports additional investments in state and local efforts, developed in consultation with teachers and other stakeholders, to implement systems that reward strong teacher performance and help less effective teachers improve or, if they do not, exit the classroom.

- **Determining what works.** The Budget also increases funding for rigorous evaluation as a first step toward doubling the Department of Education's support for education research. The Department would use this funding to conduct rigorous evaluations of approaches to improve student learning and achievement with a focus on evaluating and scaling up promising innovative practices while improving or ending programs that are ineffective.

Making It Easier to Save

To make government programs more effective, the President's Budget also looks beyond the traditional mechanisms. The Budget seeks to harness new insights into human behavior in designing government programs.

Thus, to encourage greater saving, the Budget not only expands financial incentives for low- to middle-income Americans to save more, which it does by making the Saver's Credit refundable and thus available to a much wider population; it also requires that employers automatically enroll their employees in some form of savings vehicle when they start work—either a workplace pension plan or, if the employer does not offer such a plan, a direct-deposit IRA. Employees can then elect not to participate if they so choose. Extensive research has shown that merely changing the default from non-participation to participation in a retirement plan can dramatically increase participation rates, despite the fact that workers can voluntarily stop saving. Experts estimate that, for workers generally, participation rates could about double as a result of automatic enrollment and that the effect is even larger for those with lower incomes.

This is the type of innovation the Administration is committed to applying more generally. Without expanding financial incentives, imposing penalties, or otherwise constraining people's options, programs can still encourage desired behaviors. Increasing saving rates is just one such application.

Making Key Investments

The Budget also expands Federal investment in certain key priorities. This goes hand-in-hand with making government work better for all Americans. Making government work better requires not only reducing or eliminating failing programs and increasing programmatic efficiency and simplicity but also enhancing programs that do work and deserve additional resources.

Many of these investments will increase economic growth by building the nation's capital stock, both physical and human, and spurring technological innovation. Government investment is key

to long-term economic growth, and this investment has, in recent years, been critically low in a number of respects. In addition to making these investments, the Budget also provides more resources to deserving populations, such as our nation's veterans.

Education

I have described how our proposals would reform education policy by increasing efficiency, simplicity, and transparency. The Budget goes beyond this by investing resources in programs that expand opportunity and increase quality.

- **Investing in early childhood education.** We know that a dollar invested in early education will pay off handsomely as these children get older. That is why the Administration is proposing to help states strengthen their early education programs. The Budget would broaden the reach of these programs and boost their quality, encouraging new investment, a seamless delivery of services, and better information for parents about program options and quality. In addition, through funds from the Recovery Act and this Budget, the Administration will double the number of children served by the Early Head Start program and expand Head Start, both of which have proven to be successful with younger children. Finally, the Department of Health and Human Services will begin a major new effort to ramp up the Nurse-Home Visitation program. Rigorous research has shown that a well-structured program can have large and measurable impacts in helping at-risk expectant and new parents give their children a healthy start in life.

- **Expanding higher education opportunities.** Because the Administration is committed to making college affordable for all Americans, the Budget, in addition to making the Pell program mandatory, builds on the Recovery Act by supporting a $5,550 Pell Grant maximum award in the 2010-2011 school year. The Budget would also index the Pell grant award to the Consumer Price Index plus 1 percent in order to account for inflation in this sector. Along with expansion of the Pell program, the Recovery Act created a new $2,500 American Opportunity Tax Credit, making college tax incentives partially refundable for the first time. As a result, many high school seniors who receive no tax incentives under the current system will, for the first time, receive a tax cut to make college affordable. The Budget proposes to make this tax cut permanent.

- **Helping at-risk students complete college.** It is not enough for our nation to enroll more students in college; we also need to graduate more students from college. A few states and institutions have begun to experiment with these approaches, but there is much more they can do. The Budget includes a new five-year, $2.5 billion Access and Completion Incentive Fund to support innovative state efforts to help low-income students succeed and complete their college education. The program will include a rigorous evaluation component to ensure that we learn from what works.

Infrastructure

Today, too many of our nation's railways, highways, bridges, airports, and neighborhood streets are aging and congested due to lack of investment and strategic long-term planning. In the short

term, modernizing our infrastructure would create new jobs and provide a boost to the economy. In the longer term, infrastructure investment would provide our nation a foundation for long-term economic growth. The Budget proposals include:

- **Establishing a National Infrastructure Bank.** The Budget proposes to expand and enhance existing Federal infrastructure investments through a National Infrastructure Bank designed to deliver financial resources to priority infrastructure projects of significant national or regional economic benefit. The mission of this entity will be to not only provide direct Federal investment but also to help foster coordination through State, municipal, and private co-investment in our nation's most challenging infrastructure needs.

- **Investing in our nation's roads, bridges, and mass transit.** The President is committed to instituting accountability for the $35.9 billion provided in the Recovery Act and to responsibly reauthorizing the nation's highway and mass transit programs. Further, our surface transportation system must generate the best investments to reduce congestion and improve safety. To do so, the Administration will emphasize the use of economic analysis and performance measurement in transportation planning. This will ensure that taxpayer dollars are better targeted and spent.

- **Improving and modernizing air traffic control.** Because of an outdated air-traffic control system and over-scheduling at airports already operating at full capacity, an ordinary trip to a business meeting or to visit family can become marred by long delays. The Budget provides $800 million for the Next Generation Air Transportation System (NextGen) in the Federal Aviation Administration, a long-term effort to improve the efficiency, safety, and capacity of the air traffic control system.

- **Maintaining rural access to the aviation system.** The Administration is committed to maintaining small communities' access to the National Airspace System. The Budget provides a $55 million increase over the 2009 level to fulfill current program requirements as demand for subsidized commercial air service increases. However, the program that delivers this subsidy is not efficiently designed. Through the budget process, the Administration intends to work with the Congress to develop a more sustainable program model that will fulfill its commitment while enhancing convenience for travelers and improving cost effectiveness.

- **Expanding access to broadband.** As a country, we have made significant public investments so that, regardless of economic status or location, Americans have access to telephone service and electricity. The Recovery Act does the same for broadband, and our Budget would expand upon these efforts. The Recovery Act includes $7.2 billion for broadband expansion and the Budget includes $1.3 billion in USDA loans and grants for the Department of Agriculture to increase broadband capacity and improve telecommunication service as well as education and health opportunities in rural areas.

Science

Like investments in physical infrastructure, investments in scientific knowledge also increase productivity and economic growth. The Budget proposes:

- **Doubling funding for key basic research agencies.** The President's Budget would double funding over 10 years for three key basic research agencies: the National Science Foundation, the Department of Energy's Office of Science, and the Department of Commerce's National Institute of Standards and Technology. The Recovery Act includes a $5 billion investment in these agencies, which is an almost 50 percent increase for these programs over 2008 and represents a significant down payment toward the President's plan to double funding. This initiative will help fund cutting edge research done by universities, government laboratories, and private industry. It is especially important for the government to fund such activities since basic research tends to have positive spillover effects that flow across the economy.

- **Increasing funding for research into cutting edge technologies.** The Budget also increases support for promising but exploratory and high-risk research proposals that could fundamentally improve our understanding of climate, revolutionize fields of science, and lead to radically new technologies. Such research includes interdisciplinary work like that conducted by researchers at Cornell University, who have developed a tiny nanotechnology particle that could ultimately both deliver a drug to a specific cell and monitor the cell's response to the drug; a therapeutic combination that would revolutionize medicine. In addition, the Budget funds cutting-edge, fundamental research to help transform the nation's air transportation system, increase airspace capacity and mobility, enhance aviation safety, and improve aircraft performance while reducing noise, emissions, and fuel consumption.

Energy

The Budget lays the groundwork for an agenda that would transform our nation's energy consumption. As we have known for many years now, the United States' dependence on oil and other fossil fuels undermines the country's national security, and a growing wealth of scientific evidence also suggests that this dependence is contributing to global warming, jeopardizing our economy and our entire planet.

As a down payment on an energy-independent, clean-energy economy, this Budget proposes:

- **Funding vital investments in a clean energy future totaling $150 billion over 10 years, starting in FY 2012**. To finance these investments in a fiscally responsible manner, while also providing tax relief to consumers, the Administration proposes a market-friendly cap-and-trade program to reduce greenhouse gas emissions.

- **Beginning a comprehensive approach to transform our energy supply and slow global warming**. The Administration is developing a comprehensive energy and climate change plan to invest in clean energy, end our dependence on oil, and address the global climate crisis. The Administration plans to work expeditiously with key stakeholders and

Congress to develop an economy-wide emissions reduction program to reduce greenhouse gas emissions approximately 14 percent below 2005 levels by 2020, and approximately 83 percent below 2005 levels by 2050. This program will be implemented through a cap-and-trade system.

- **Building on the Recovery Act's investments in a new economy that is powered by clean and secure energy**. The Budget will build on the Recovery Act's investments by significantly increasing funding for basic research and transformational science to accelerate solutions to our nation's most pressing problems. The Budget also supports the transition to a low-carbon economy through increased support of the development and deployment of clean-energy technologies such as solar, biomass, geothermal, wind, and low-carbon emission coal power, and it builds on the $11 billion provided in the Recovery Act for smart grid technologies, transmission system expansion and upgrades, and other investments to modernize and enhance the electric transmission infrastructure to improve energy efficiency and reliability.

- **Creating a New Energy innovation fund.** The Budget includes funds for HUD to drive the creation of an energy-efficient housing market—including the "retrofitting" of older, inefficient housing—and catalyze private lending for this purpose in the residential sector. Partnering with the Department of Energy on this initiative, HUD will contribute to the Administration's broader effort to combat global warming, jumpstart the creation of a clean-technology economy, and reduce utility bills.

Veterans

While investing for the future, the Budget also devotes more resources to deserving populations, such as our nation's veterans. The Budget expands support for our nation's veterans by:

- **Increasing funding for Veterans Affairs (VA) by $25 billion over the next five years.** The President's Budget increases funding for VA by $25 billion over the next five years in order to honor our nation's veterans and expand the services they receive. Some of these funds will be used to transform the VA into a 21st-century organization, including investments in information technology that directly benefit veterans in the areas of both health care and benefits.

- **Dramatically increasing funding for VA health care.** The President's Budget provides VA medical care with the resources it needs to provide 5.5 million veterans with timely and high quality care.

- **Restoring health care eligibility for modest-income veterans.** For the first time since January 2003, the President's Budget restores eligibility for VA health care to non-disabled veterans earning modest incomes. By 2013, this initiative will bring over 500,000 additional veterans into the VA health care system while maintaining high quality and timely care for the lower-income and disabled veterans who currently rely on VA medical care.

Conclusion

The President's Budget strikes a new course for America. It presents the fiscal path with honesty, and deficits are projected to fall in half by the end of the President's first term compared to the deficit inherited by the Administration when it came to office in January 2009. Altogether, the policies in the Budget would reduce the deficit by $2 trillion over the next 10 years, begin to address the key contributor to the nation's long-term fiscal short-fall by proposing health savings measures that could help "bend the curve" on long-term health costs, begin the process of reforms to improve how government works, and, finally, make key investments that would provide much-needed jobs now and boost long-term economic growth

The country faces grave challenges, both in terms of its short-term economic health and its long-term fiscal future, and working our way out of these difficulties will not happen overnight. The policies proposed in this Budget and those enacted last month in the Recovery Act represent an important first step on the path back toward economic and fiscal health. I look forward to working with you in the weeks and months ahead to continue the process of addressing the challenges facing our nation.

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Chairman CONRAD. Thank you for your excellent testimony.

Let us get right to it, because as I have said publicly and said here at the beginning of this hearing, I do believe there are important priorities here in energy, reducing our dependence on foreign energy. While oil prices are low now, I think all of us know that is not likely to go on forever and this is central to the economic and national security of America that we reduce our dependence on for-

eign energy. And that is one of the key components of the President's budget.

No. 2, excellence in education. If we are not the best educated people in the world, we cannot long expect to be the most powerful country in the world.

And finally, on health care, it is the 800-pound gorilla. Anybody that has spent 5 minutes studying the numbers know that your testimony is correct, that health care is where it is at.

With that said, we are at about 17 percent of our Gross Domestic Product on health care and it appears to me that under almost any possibility, a proposal from the President will increase in the short term the share of the economy going to health care. And then we look at the revenue side of the equation. Under the President's proposals, we have spending that is about 22 percent of GDP in the out years, revenue roughly 19 percent of GDP, for that 3 percent gap.

What do you see as a mechanism for addressing this long-term imbalance?

Before you answer, I want to make clear, people listening may have heard me talk about debt-to-GDP at over 100 percent. That is gross debt. You may have heard Senator Gregg, the Ranking Member, talk about debt-to-GDP of some 70 percent. That is publicly held debt. So there are two different measures of debt. I just want to make that clear to people listening. It is not that Senator Gregg and I have different numbers. In fact, our numbers are precisely the same. They are just two different measures of debt.

So my first question to you would be, do you believe a gross debt-to-GDP of 100 percent is sustainable for this country given the baby boom generation? If not, what mechanism do you believe will be necessary to address it?

Mr. ORSZAG. Well, I prefer to focus on the publicly held debt and the ratio there would be something like 60 percent. I think we have seen—while obviously it would be desirable to reduce it further, we have seen other countries and even the history of the United States bear a debt burden that high.

And again, I want to just emphasize, even—if you pull up your chart up again on the gross Federal debt, what you see is a dramatic increase reflecting the condition that we are inheriting and the steps necessary to address it, and then a leveling off. What we are trying to accomplish over the next five to 10 years is a fiscal sustainability path where you are leveling that ratio and then investing in the key steps that will bend the curve on health care costs over the long term, since as this graph, or the graph had shown, that is the key to bringing that debt ratio down over the long term.

And you had mentioned an expansion in national health expenditures. I think, if anything, there will only be a modest expansion in the near term. But the more important point is that the power of compound interest is so strong that if you can reduce the rate of health care cost growth by, say, 100 basis points, 1 percent a year, the impact after 40 or 50 years is huge. So 1 percent a year compounded over 50 years saves you almost 20 percent of GDP in health care expenses.

The entire ballgame is whether we can put in place the structural changes to our health care system to reduce that growth rate, and I believe we are doing everything that the Institute of Medicine, of which I am a member, Congressional Budget Office, which I used to run, and MedPAC—that anyone has put on the table in terms of bending the curve on long-term costs, and if we are not, I would welcome more suggestions, but I think we are as forward-leaning as you possibly can be in investing in health IT, comparative effectiveness, changing incentives for providers, investing in prevention, and I would welcome other suggestions because I think that is the whole ballgame.

Chairman CONRAD. Let me just say, I agree almost entirely with what you say with one exception and that is I never hear anybody talk about the revenue base of the country around here. And we have shown repeatedly that we are unwilling as a country to pay for what we want to spend. And so until we address not only health care but the revenue base of the country, I don't think we are going to get to where we need to go.

Let me just say, I am going to end my questioning there on 5-minute rounds. We are going to ask 5-minute rounds from everybody today because we have just been informed there will be votes starting at 4, and given the turnout, I think that is the only fair thing to do.

Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman.

I think you hit the nail on the head. The difference between the revenues and the spending is what creates the problem and drives the debt up, and unfortunately, under this budget, the administration is planning to take spending after the spike for the purposes of addressing the fiscal problems we have up to 22, 23 percent of GDP, as you can see from this chart, which is way above, way above where we have been historically, and it goes on forever and that is the problem, that the spending in this bill is huge and most of that spending is driven by what the Director has said very openly is the desire of the administration to spend more on education, health care, and a variety of other Federal areas other than defense in this bill. So it is a spending problem, in my opinion.

But to move to a more specific issue in this bill which I am trying to get clarification on, and that is the cap and trade tax, which you estimate in this bill is going to generate, I think about $65, $67 billion annually, or something in that range—I have forgotten what the number was. But MIT, in scoring the same—the bill that was out there last year, which is the bill of record and which is, one presumes, the mechanism that will be used, an MIT study scored that at generating about $300 billion a year annually. That is a massive new tax. It is a tax on energy and it will flow directly through to the consumer in the form of a national sales tax on their electric bill, which I know the Director agrees with because he said that when he was Director of CBO, that that tax will flow to the consumer.

And so I guess my question is, is that accurate, that you are putting in place, or proposing to put in place a massive new tax which will flow through to the consumer? Now, I understand you are going to take that and rebate it to some other consumers through

one of your tax mechanisms here, your tax deduction mechanisms—I have forgotten the name of it, I am sure you will explain it to me—up to 80 percent, but there is still 20 percent that is floating around as slush money for whatever the spending that we want to put it on as a Congress.

But more importantly, how do you explain to that electric utility user, most likely in the Midwest and the Northeast, that their energy bill, their electricity bill is going to spike a little bit—quite a bit—as a result of this new tax?

Mr. ORSZAG. Let me comment on various aspects of that. First, the budget includes $15 billion a year in energy efficiency investments, for example, the kind of thing that we need to take wind energy from the Dakotas and connect it to population centers, because we have got lots of wind energy in parts of the country but we can't get it to where people——

Senator GREGG. Are you going to get that money from this tax revenue? Is that where you are planning to get that $15 billion? Is that where some of the money is going?

Mr. ORSZAG. No, to finance those investments in a fiscally responsible way, we do have a market-friendly cap and trade program.

Senator GREGG. Market-friendly. You keep——

Mr. ORSZAG. Like in the sulfur dioxide program, firms will be able to trade permits and economists across the political spectrum agree that a cap and trade program is an efficient approach to reducing greenhouse gases because it allows firms to be flexible in terms of how they get efficiencies in reducing greenhouse gases.

Senator GREGG. Independent of that, would you answer the specific question——

Mr. ORSZAG. Yes.

Senator GREGG [continuing]. Which is, is there a potentially $300 billion new tax, using MIT numbers, on energy consumers?

Mr. ORSZAG. I haven't seen those estimates. I think that sounds remarkably high to me——

Senator GREGG. That was the number that actually the Obama campaign used during the campaign.

Mr. ORSZAG. I don't know what the Obama—as you know, I was at the Congressional Budget Office and didn't pay attention to campaign undertakings while I was there. But let me just note that what the President has said is that he supports reducing greenhouse gas carbon dioxide emissions by 14 percent relative to 2005 levels by 2020. There are many different paths to get there——

Senator GREGG. How much will the tax be?

Mr. ORSZAG. Again, I don't—I can't answer the question because there are lots of different ways——

Senator GREGG. How much are you scoring in the budget as raising——

Mr. ORSZAG. In the budget we——

Senator GREGG [continuing]. Annually by this new energy tax on consumers?

Mr. ORSZAG. OK. I also need to just address the semantics for a second, but I will do that in a moment. We have roughly $640 billion over 10 years, $646, coming from the sale of permits——

Senator GREGG. So is that $64 billion a year annually, if you were to average it out every year?

Mr. ORSZAG. Now are you going to allow me to address the semantic issue?

Senator GREGG. Oh, of course——

Mr. ORSZAG. OK.

Senator GREGG [continuing]. You can address the semantic issue.

Mr. ORSZAG. All right. So I think we have a common understanding of a tax is something that is collected through the tax code. On that basis, the budget delivers a tax cut for 95 percent of Americans, and actually if you adopt the baseline that Mr. Conrad favors, it may be even more than that.

There are lots of other effects of the budget—Pell Grants that help kids go to college, early education investments, early Head Start. You either have to do the analysis kind of all in on the financial impact on households or just look at the tax code. So unless we are going to start calling Pell Grants a tax cut, I think incorporating the secondary effects of policies that are not run through the tax code and calling that a tax, well, it is not the semantic approach that I would adopt.

Senator GREGG. Well, you are going to raise $646 billion over 10 years. It is not going to come from Tinkerbell. It is going to come from consumers and that is—I mean, the consumer is going to see it as a price on their energy bill. You can call it a tax. You can call it an increased price for energy. But their bill is going up.

Mr. ORSZAG. I agree there will be increased prices, yes.

Chairman CONRAD. Senator Cardin.

Senator CARDIN. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Cardin, if you would withhold just a moment, maybe I could just go down the list as we have it here so people know where they stand. Cardin, Sanders, Murray, Whitehouse, Stabenow, Warner, and Merkley on our side. On the other side, Sessions, Alexander, and Graham.

Senator CARDIN. Thank you, Mr. Chairman, and Director, it is nice to have you before us here.

I do want to start off by congratulating the Obama administration for presenting an honest budget. It is good to see all of the expenditures that we are going to incur included in the budget so that we can really have, an intelligent discussion in the Budget Committee and try to be on the same page with the administration as we make policy decisions.

I want to talk about health care, because I was interested in how you framed some of the budget scorekeeping here. We need to get to universal coverage for many reasons. Forty-seven million people without health insurance is extremely expensive to our economy and your charts point that out very clearly.

Now, when we get to universal coverage, it will have a dramatic impact on the cost of health care. We currently spend twice as much as comparable countries spend on health care and we don't have the results to reflect that type of investment. So if we can reduce or eliminate the number of uninsured, we will reduce the number of people using emergency rooms and we will have much greater use of preventive health care, which will save lives and save tax dollars. If we have a more efficient system of health care

delivery, that will clearly save money. We will have fewer people going into bankruptcy. That will also save money for our economy. All of that will have an impact on our future economy and on our deficit and on our budget.

It is interesting that this committee, and Mr. Chairman, I am going to ask that a copy of this letter be made a part of our record——

Chairman CONRAD. Without objection.

Senator CARDIN [continuing]. Received a letter from a group of entities suggesting that CBO's current scoring conventions do not recognize many of the savings to be achieved by restructuring of our health care system. It reads, "We believe, therefore, it would be reasonable to develop an approach for health care reform that reflects both the near-term exigencies and long-term savings of such extraordinary legislation."

Senator CARDIN. Now, the signatories of signed this letter include the U.S. Chamber of Commerce, the AFL–CIO, the American Hospital Association, the American Medical Association, and the National Federation of Independent Businesses. These aren't exactly radical groups when it comes to trying to spend more government funds. But what I think they are trying to do is get an honest assessment of how our budgets are going to address health reform.

Now, you have a placeholder in the budget for what you think reform will cost, a little over $600 billion. I believe if you use current values for President Clinton's health care proposal, it would probably add up to about $1.1 trillion. I think some of us question whether there is enough room in the budget outline you have proposed—knowing how we do our budget scoring here—to be able to achieve universal coverage, because we want to see major health care reform in 2009.

So my question to you is, what type of budget do you need coming out of this committee so that the committees working on health care reform can get the job done in 2009? I am concerned that we may not have enough direction from you now as to what is necessary so Congress can, in fact, take up this issue in 2009.

Mr. ORSZAG. Thank you for that question. As we noted in the budget document, the reserve fund was intended as a downpayment, and as you noted, there are lots of plans out there that would require more resources and there are lots of ideas that have been put forward to fill in any gap between how much we have already put on the table and how much would be required.

In terms of what would be necessary in the budget resolution, we feel quite strongly that health reform should be deficit neutral over the next five to 10 years and also help to reduce costs over the long term. So in a sense, all that is required is a mechanism for ensuring deficit neutrality as part of the health reform effort. We have tried to kick-start that process by putting substantial resources on the table, including significant savings in Medicare and Medicaid, and we look forward to working with you to fill in any additional amounts that might be necessary.

Senator CARDIN. But do you agree that if we get this done right, if we can get a handle on the resources that our economy currently puts out for health care that the future benefits to our economy

and to the budget we are considering, including the deficits, will be much easier for us to address

Mr. ORSZAG. Without question. That is why we are trying to get—that is why we have put such an emphasis on getting health reform done this year, because without it, the path that we are on is unsustainable, and with it, there are other changes that are still necessary in terms of our long-term fiscal picture. But that is the single most important thing we can do, and I am just going to repeat, if other people have ideas about what might help bend the curve, I am all ears. But I believe we have been more forward-leaning than any budget I have ever seen in terms of putting in place health IT, comparative effectiveness, changes in incentives for providers, and prevention and wellness efforts to help bend the curve.

Chairman CONRAD. Thank you.

Senator Alexander.

Senator ALEXANDER. Thank you, Dr. Orszag. Thank you very much for coming.

Just an observation on Senator Gregg's comment about the national sales tax on energy or gasoline. I am one Senator who wants to deal with climate change and have introduced legislation that would put a cap and trade system only on power plants. But as we look at it from the TVA region, where 10 percent of the customers in Nashville said they couldn't pay their electric bills in December because of TVA's rates, which are relatively low, we would be asking them to pay even more for, in effect, a carbon tax.

Then under your proposals we have gone from about $5 billion to about $20 or $25 billion a year in subsidies to banks and developers and big companies to build wind turbines in another part of the country. And you also now want to spend hundreds of billions of dollars, some of which we would have to pay, to build transmission lines from the other part of the country to Chicago and New York to carry that kind of energy. Typically, transmission lines have been paid for by the ratepayers who use the electricity and that is a separate discussion.

But I would like to ask you about two education issues. I appreciated being invited to the Summit on Fiscal Responsibility and thought the President did an excellent job there and appreciate his focus there. The Republican Leader has said he is ready to go to work on that, starting with Social Security and then I believe we should do health care this year.

But I was surprised to come back and then, the President in his budget would propose making Pell Grants mandatory, because if I am correct, that would take $117 billion and move it over to the automatic pilot spending side of the budget for the next 10 years. Why shouldn't we be going in the other direction? We spent all afternoon down there being told by a whole number of people that our big problem was entitlement spending and you are proposing to add another $117 billion over 10 years.

Mr. ORSZAG. Three comments. First, we propose significant savings by reducing and eliminating the subsidies for middlemen on education loans because the evidence suggests that there is a more efficient way.

Senator ALEXANDER. I will have a question about that next.

Mr. ORSZAG. OK, great. The second is then let us examine the policy rationale for making Pell Grant funding more secure. I think the evidence is overwhelming that one of the reasons that current enrollment rates are not as high as they should be, especially for moderate-and low-income families, is that in ninth and tenth grade, too many kids don't aspire to go to college in the first place, in part because the existence of financial assistance is unclear, and if you look at the pattern of funding for Pell Grants in the past, it has been a zig-zaw, you know, up and down kind of thing. And second, that the process of applying for it is too complicated.

So the vision, and the President is talking about this today, or already talked about it——

Senator ALEXANDER. I only have about a minute and a half and I have other questions.

Mr. ORSZAG. OK, I am sorry. I will be really brief. You want to inspire kids to aspire to college, and that is what we are trying to do.

Senator ALEXANDER. But the fact of the matter is, you are moving $117 billion over to entitlement spending, which is where we already have the problem.

Are you then going to spend the money twice by figuring you have left a $117 billion hole in discretionary spending and then spend that, too?

Mr. ORSZAG. No. In fact, the reductions in non-defense discretionary spending that are discussed net out Pell Grants and the historical data——

Senator ALEXANDER. So you are only spending on the mandatory side, not on the discretionary side?

Mr. ORSZAG. Well, there is a downward adjustment on the discretionary side, but I didn't want to conflate the analysis by making that look like a reduction in discretionary spending. So we took Pell Grants out of the——

Senator ALEXANDER. I want to make sure. Are you going to spend it both——

Mr. ORSZAG. No.

Senator ALEXANDER [continuing]. On the mandatory side and then spend 117——

Mr. ORSZAG. No.

Senator ALEXANDER [continuing]. And then say, I have got $117 billion——

Mr. ORSZAG. No.

Senator ALEXANDER. OK, good. Now may I move to the other part of your vision and give you a moment to answer that?

Mr. ORSZAG. Yes.

Senator ALEXANDER. I was Education Secretary when the direct loan program started. I didn't think it was a good idea then and I don't today. And the reason I didn't was partly because I didn't think it would save any money. There have been arguments about that on both sides for the last 10 years. I still don't.

The second reason was a bigger reason. It was a management issue. We have got 6,000 higher education institutions across the country. We have got 15 million new loans to students every year. And you are going to turn that over to the United States Depart-

ment of Education suddenly to manage? Arne Duncan, I think, may be the President's best appointee, with all courtesy to you——

[Laughter.]

Senator ALEXANDER [continuing]. Among the most distinguished appointees.

Mr. ORSZAG. OK.

[Laughter.]

Senator ALEXANDER. But even he, I don't think, can take over the management of the millions of new loans that instead of being managed by lenders all across the country to 12 million or 13 million students would now be managed by the United States Department of Education in Washington where I used to work.

Mr. ORSZAG. Senator, first of all, I will make sure I pass along your warm regards to Secretary Duncan.

Senator ALEXANDER. I have already told him.

Mr. ORSZAG. OK. A couple comments. First, I think the evidence is actually clear. I don't think there is ambiguity. The direct lending program does save money relative to an alternative in which the Federal Government guarantees private loans.

Second, that private loan market itself has been experiencing significant difficulty, if you just look at what has been happening recently. So the argument that there would be problems in the direct lending program, I think doesn't take into account the difficulties that the private lending program is experiencing.

Finally, before putting this forward, we did do significant work to make sure that the program could ramp up adequately so that there would be no disruptions and I believe that there would be a smooth ramp up if this proposal were adopted.

Senator ALEXANDER. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Sanders.

Senator SANDERS. Thank you, Mr. Chairman, and welcome, Mr. Orszag.

I want to go over three issues quickly: Income inequality, Social Security, and health care.

No. 1, under President Bush, poverty increased, the middle-class shrank, and the wealthiest people became much wealthier. But what we have seen is that despite the fact that the top 400 Americans in this country saw a huge increase in their net worth, in fact, by $640 billion from 2001 to 2007, a huge amount of money for a few people, actually, today, these wealthiest 400 Americans now pay a lower tax rate, lower effective tax rate than most police officers, teachers, nurses, and people in the middle class. What do you think about that and what are we going to do about it? Do you think that is right, and should we change that?

Mr. ORSZAG. One of the reasons that in 2011 and thereafter the President has asked for some rebalancing of the tax code and for more contribution from the very high-end of the income distribution is precisely the trends that you have identified. The top 1 percent of the population enjoyed ten—or accrued 10 percent of national income in 1980. It is now up to almost 25 percent.

Senator SANDERS. OK. Thank you. And I agree with you, I should tell you.

Social Security—I happen to think there is not a Social Security crisis. Social Security will, in fact, be able to pay full benefits to

every recipient for at least the next 32 years and after that it will be able to pay out 75 percent benefits. During the campaign, a candidate, you may recall his name, Barack Obama, this is what he said. Quote, "What we need to do is raise the cap on the payroll tax so that wealthy individuals are paying a little bit more into the system," end of quote. It is a longer quote. Is that still the position of the Obama administration in terms of addressing the Social Security crisis?

Mr. ORSZAG. I would just say there are lots of options for eliminating the actuarial imbalance in Social Security we face. I mean, benefits are higher than projected revenue and that needs to be closed.

Senator SANDERS. Let me go back again. Do you consider it a crisis when we can pay out every benefit owed to every eligible American for the next 32 years, and by lifting the cap, we could essentially solve the problem? And this is what the candidate Barack Obama was talking about. Has there been a change in policy?

Mr. ORSZAG. I wouldn't say Social Security is in crisis. It does face a long-term deficit that needs to be addressed and it should be addressed.

Senator SANDERS. Are you still thinking about raising that cap?

Mr. ORSZAG. Again, I am just going to say there are lots of options on the table.

Senator SANDERS. All right. The third question, I want to thank you and the President very much. In the stimulus package, there was $2 billion appropriated for Community Health Centers, $300 million for the National Health Service Corps so that we can begin to get doctors and dentists and nurses out into underserved areas. And all of the studies indicate that if we expand the Community Health Center program, if we get doctors into underserved areas, we end up saving money because people don't end up in an emergency room or the hospital.

You guys did, I thought, a tremendous job in the stimulus package. Will you continue to support in a significant way Community Health Centers so that, in fact, we can have a center in every underserved area in our country?

Mr. ORSZAG. Yes, and also the other piece of that, on the work force issues, there is also a few hundred million dollars in this budget——

Senator SANDERS. Exactly.

Mr. ORSZAG [continuing]. To buildupon the effort that was in the Recovery Act.

Senator SANDERS. All right. So is that still a goal of yours?

Mr. ORSZAG. Absolutely. Yes.

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

Chairman CONRAD. Thank you.

Senator Graham.

Senator GRAHAM. Thank you, Director Orszag. I think you were a good choice.

Mr. ORSZAG. Thank you.

Senator GRAHAM. A suggestion. Climate change—if you are serious about climate change solutions, there is going to be some increased cost. That is just inevitable. But the problem I have with your approach is that you go to a 100 percent auction and I know

hedge funds are going to jump into this and drive up the price of the credit and those industries that use a lot of energy, particularly in some out in the Midwest and other places are going to have a hard time in a 100 percent auction world of paying the cost until we get a solution. The fact that you use the revenues to go to your Make Work Pay program, which quite frankly is a tax policy that I don't agree with, is going to make it very difficult for you to pass climate change.

So my recommendation would be that whatever revenue is generated from a cap and trade system, that it be less radical in terms of the 100 percent auction, that we understand that China and India are part of this problem, and if we do too much too quickly, we are going to drive people offshore and they are already leaving, and that when you take the revenue and put it into a tax program that there is division that you probably have thrown an issue into the climate change debate that has not existed and I think effectively destroyed the ability to solve the problem. That is just my opinion.

Mr. ORSZAG. Could I comment on the 100 percent auction for a moment?

Senator GRAHAM. Yes, please.

Mr. ORSZAG. I think this is important. If one did not auction the permits under a cap and trade program, the result would be, in a sense, the largest corporate welfare program that the government ever created because you would be transferring whatever the value of those permits were, whatever it turns out to be, you would be transferring it almost directly into a corporation's bottom line. And so the motivation for the——

Senator GRAHAM. I understand, but every other climate change solution in this building has had an allocation system because we don't see compliance. People are going to have to pay more. Industry is going to have to pay more. The people who are in manufacturing that use a lot of energy are going to be hit with this because they are emitting the most carbon. I understand that. But if you do too much too quickly, and if you don't recognize that hedge funds and other groups are going to jump into this auction system and drive up cost, well, then you have lost me. I will just be honest with you.

There are a lot of folks who believe that climate change is real, that CO2 emissions are heating up the planet, and we need to find a solution. But your $646 billion revenue stream, I think assumes some things that are too far, too fast, and using the money to pay for a Make Work Pay program that is a different issue where there is more division, I will just leave it at that. I think you have done a lot to damage, quite frankly, the ability to find common ground on climate change.

Now, when it comes to defense spending, right now, 4.1 percent of Gross Domestic Product is spent on defense. In the budget, is it fair to say that 10 years from now, it will be 3 percent of GDP?

Mr. ORSZAG. It would be reduced, yes.

Senator GRAHAM. I just had a hearing with Admiral Blair, who I think is another good choice, and he gave us the threat assessment our nation faces, and I came away thinking that we are equally at risk, if not more at risk, over time. Do you think it is

wise, given what this country faces in the next 10 years in terms of military threats and international crisis, to reduce defense spending?

Mr. ORSZAG. Well, again, wait. Reduce as a share of the economy. But let me actually speak directly to this.

Senator GRAHAM. OK.

Mr. ORSZAG. Secretary Gates has stated that given the significant run-up in the defense budget, it is time to sort of change course and start applying more discipline—for example, in the procurement part of the budget, you have almost $300 billion in cost overruns because there has been very little discipline applied——

Senator GRAHAM. Director Orszag, I agree that procurement and acquisition reform—no one should get a pass here. The Pentagon can do better. But we are going to increase the Marine Corps and the Army, as we should. But the biggest——

Mr. ORSZAG. And the budget does that.

Senator GRAHAM. Exactly. The biggest cost of the military is personnel cost. So when you increase your personnel cost, something has got to give. And if you are going to reduce the overall pie, that means there is going to be less money for weapons systems that are efficient. And so I would just look long and hard about the glide path you have put us on when it comes to meeting the national defense threats that we face, and I think this is, quite frankly, a reckless move at a time when our nation is very much at threat.

Finally, in 2009, the percentage of Federal spending that goes to interest payment on the national debt is 3.53 percent. In 2019, it is 12.06 percent. Where does that take us as a nation? If this continues where that percentage grows over time, what is the outer limits of the United States Government's ability to borrow money? When do we hit those outer limits and what does it mean?

Mr. ORSZAG. Well, first, I don't believe that—actually, net interest is not anywhere close to that in 2019 as a share of the economy. But let me come back to the basic point. Because of the economic difficulties that we are inheriting, there is a significant increase in debt that has already occurred and that will occur this year, and then the whole goal of the budget is to stabilize that as a share of the economy while also dealing with health care, which is the key to our long-term future. Net interest will track that change in debt.

And I also do, because I agree with you it is crucial——

Senator GRAHAM. I don't mean to interrupt, but I am talking about the amount of money spent to service the interest of the Federal spending. It is 3.5 percent now. Of the budget, 3.5 percent goes to pay interest on the national debt. In 2019, it is 12.06. Am I wrong?

Mr. ORSZAG. I believe so, yes.

Senator GRAHAM. OK. If I am, I stand corrected.

Mr. ORSZAG. I think it is more like 2.7 percent, so reduced from current levels.

Chairman CONRAD. I think you are talking about share of the budget.

Senator GRAHAM. Yes, I am. I am talking——

Chairman CONRAD. Versus share of the economy.

Senator GRAHAM. Exactly. Twelve cents of every dollar the Federal Government will spend in 2019 is to pay the interest. Am I wrong?

Mr. ORSZAG. That is approximately correct, yes, 622 over——

Senator GRAHAM. And if that continues unchecked, how does that affect this Nation's ability to borrow money to meet the obligations——

Mr. ORSZAG. One of the reasons why we have to reduce the fiscal—you know, address the fiscal path that we are on is, if we do not, debt and deficit and that interest explode in cost over time. There is no question about that. This budget, relative to doing nothing, reduces the deficit by $2 trillion. And more important than what happens over the next 5 or 10 years, I want to come back again—because I feel very strongly about this. If we do not address the excess cost growth rate—that is, the rate at which health care costs are growing relative to income per capita—whatever happens over the next 5 or 10 years is not going to matter.

In order to address our long-term fiscal problem, that is the key thing we need to do, I think we are being as aggressive as—I mean, again, I would welcome thoughts. If anyone else has other things that, you know, the Institute of Medicine or others have not come up with, let me know, and we will work with you on them. I think we are as forward-leaning on that question as you could possibly be.

I also just want to come back—and I do not know if Secretary Gates will be testifying before the Committee, but I defer to——

Chairman CONRAD. Well, we would like to have the Secretary come. He has not expressed a willingness to come. I think that is a significant mistake at a time like this for the Secretary or the Deputy Secretary not to come. But so far they have resisted the invitation of the Committee to come.

Mr. ORSZAG. Well, I would, again, just defer to him on the appropriate level of funding for our defense effort, because, again, he thinks that what we are doing is in the Nation's best interest.

Chairman CONRAD. Senator Murray.

Senator MURRAY. Thank you very much, Mr. Chairman. And I, too, wanted to say that I am pleased that we have a budget that addresses some of the realities that have been ignored for some time. We are going to have earthquakes or floods, and we need to budget for that. The cost of the war is a reality, and I appreciate a budget that comes to us that addresses that, and at the same time says we have got to get our arms around some very critical issues—energy, health care, education—in order to make sure that we have a strong economy in the future so that we can deal with the debt. So I thank you for that.

Let me ask you some specifics. In reading through some of the budget highlights in the document, I was glad to see the Department of Energy's budget, and I quote, "continues the Nation's efforts to reduce environmental risk and safely manage nuclear material." While that bullet is last on the list of highlights, I trust it is not the least, because I know the administration shares my dedication to pursuing both the moral and the legal obligation to clean up the environmental management complex.

You and I have had the opportunity to talk about this many times. You know it is a high priority of mine. I have been very concerned about the previous administration's failure to comply with clean-up agreements with the States and 4 years of declining budget requests that have put us in jeopardy.

Here in Congress, we have worked annually every year to backfill, and most recently in the fiscal year 2009 omnibus and the Economic Recovery Act. This is not a fight we should have every year. This is an obligation, and I am looking for at least $6.5 billion in the fiscal year 2010 request when the details are finally announced, and I wanted a chance to ask you today if that is what we are going to see.

Mr. ORSZAG. Well, as you know, the Recovery Act provides substantial funding for environmental management. I think it would be premature for me to be committing to specifics for the detailed April budget at this point, but I know it is a priority of yours, and we——

Senator MURRAY. The Economic Recovery Act put money in to reduce the size of the footprint overall complex around the country so that we would not continue to have to pay the high maintenance costs. But that does not take away our obligation every year in the annual budget. I assume you understand that.

Mr. ORSZAG. I do understand that.

Senator MURRAY. OK. Well, I will be looking forward to seeing what you put out.

Mr. ORSZAG. I know you will be.

Senator MURRAY. I also wanted to ask you about the VA, and we had a hearing this morning in the VA Committee with Secretary Shinseki, and we are hearing rumors that the administration is going to propose allowing the Department of Veterans Affairs to bill third-party insurers for the care of conditions that are related to a veteran's service-connected disability or injury. I am sure if you are not aware, you will be aware that our offices are hearing from veterans who are understandably very upset about a proposal such as that.

Can you tell me if you are planning to include a third-party billing proposal in the VA budget?

Mr. ORSZAG. Well, there will be more details about the VA budget in April, but let me state very clearly that there will not be increases in out-of-pocket costs or premiums for veterans. And, in fact, the budget adds $25 billion over 5 years for veterans and covers roughly a half a million more veterans under the VA system.

Senator MURRAY. But is this specific proposal one that you are looking at?

Mr. ORSZAG. There are lots of proposals that are being examined. I think it would be premature to be discussing specifics.

Senator MURRAY. OK. Have you looked at the revenue impact of a proposal like that?

Mr. ORSZAG. Again, I am going to just say it is premature to be discussing specifics. That will be part of the April budget.

Senator MURRAY. OK. Well, in honesty in budgets, that is probably a proposal that is DOA when it gets here, so if we want to be honest, we better be careful what we are requesting.

Mr. ORSZAG. OK.

Senator MURRAY. Let me go back to education really quick in my last minute. Senator Conrad mentioned it as well. We have got to educate people today for the jobs that are going to be out there, whether they are health care or green energy or whatever it is. And if we do not do that, all is going to go to naught for all the money we are putting out there to try and get our economy back on track.

I chair the Workforce Investment Subcommittee, and we have been trying to reauthorize the Workforce Investment Act, which is really the backbone of our national efforts, and I wanted to ask you if the administration was going to work with us to try and get that authorized so we can move forward and give people the skills they need to be able to compete in the jobs that we want them to be in.

Mr. ORSZAG. Absolutely, and I believe the President touched upon that topic in his speech today, too.

Senator MURRAY. OK. Thank you very much.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman.

Welcome back. Peter, I applaud the more honest picture that this budget presents, and I applaud its focus on the long-term challenges we face, which are severe, in energy, education, and, most particularly, in health care. You know how I feel about the health care question, and I could not be happier that it is here.

If you look at what I have long considered to be the guidepost for this reform, it is information technology infrastructure; it is improvements in quality and in prevention investments in areas that will save costs overall; and it is reform of the payment system so that we are sending a signal with our dollars that matches from a societal point of view what we want Americans to enjoy, which is better health care. And I think the budget touches on all those areas in important ways.

My mental image of this is that our current system is like a cruddy old plant that runs and breaks half of the stuff as it makes it. It catches on fire every second or third day and wastes an enormous amount of oil and energy and is really bad design, bad systems design. We can move to a better, more efficient one that produces a better product with less casualties and less cost and less waste and less aggravation and all of that.

If you were in a factory floor and you were making that transition, you would not only put investment up, which you do, but you would also have somebody responsible for managing that transition. And what I do not see yet is how this transition is going to be managed. I do not think CMS can do it. I do not know that you want to have this managed directly out of the White House on a day-to-day basis. I know that we in Congress cannot do it. We can do great big, simple, blunt moves. But the type of dynamic oversight of a multivariable, ongoing process on which, I think we believe in many respects, the fiscal future of the Nation depends is going to be quite a challenge. And that is what I do not see.

How is that transition going to be managed? It is one thing to put this downpayment down, bravo for you, it is brilliant, and I

will work with you as hard as I can to make sure you get all the support you need. But how do you manage it?

Mr. ORSZAG. Well, there are different approaches. It will depend on what is done in the legislative process over the next few weeks and months. I will give you a couple examples.

Senator Baucus has proposed a health institute or a health board that would manage a lot of those decisions.

Senator Rockefeller has proposed something similar, basically MedPAC on steroids, where a technically competent body would help guide——

Senator WHITEHOUSE. Some type of authority.

Mr. ORSZAG. Authority, would help guide those decisions. Under the Healthy Americans Act, the role of the exchanges is crucial, as it is in Massachusetts with the Connector. So there are lots of different models.

Senator WHITEHOUSE. I am relatively familiar with the legislative proposals. What I do not see is an administration proposal.

Mr. ORSZAG. Oh, I am sorry. And from the administration perspective, Governor Sebelius will be making visits this week. We would like her to be confirmed as quickly as possible. The White House has named Nancy-Ann DeParle as the White House Coordinator on Health Reform, and she will be visiting up on the Hill, working with staff and with Senators and Members of Congress starting this week.

So we are ready to roll up our sleeves, and it is going to—I mean, the fact of the matter is it will require a team effort from the administration along with a team effort from the Congress to get this done.

Senator WHITEHOUSE. So there is no fixed administration position at the moment on how this should be managed. You know that it should be, you are aware of the different options that are out there, and Governor Sebelius will be coming on board, and then you will sort through it. Is that——

Mr. ORSZAG. Well, no, I would—OK. So there is how you actually manage the system itself versus how you manage the policy process. The policy process naturally will depend on not only hopefully soon-to-be Secretary Sebelius but also Nancy-Ann DeParle, and then clearly other members of both the economic and other teams will be involved—Secretary Geithner, Larry Summers, myself. Health care touches upon so many aspects not only of the economy, but of the Federal budget and State government. It is natural that a team effort will be required, and we will be presenting you with a team, and there will be clear points of——

Senator WHITEHOUSE. I am hearing you saying this is going to be actually managed at a very senior executive level——

Mr. ORSZAG. Absolutely.

Senator WHITEHOUSE [continuing]. Rather than turfed off to an organization.

Mr. ORSZAG. No. This is going to be managed at the highest levels, yes.

Senator WHITEHOUSE. I think my time has expired. Thank you.

Chairman CONRAD. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and let me add my voice to those who applaud the honesty in the budget and also

some of the policy directions. We may have some differences on how we get there, but I think the policy directions are headed in the right way.

One concern that I have is that while recognizing we are in this enormous economic challenge, which generated the requirement for the American Recovery and Reinvestment Act—and you have laid out a very bold agenda going forward—an area that may not be quite as sexy but one that I hope would get requisite attention is how those funds that are being spent are at least spent efficiently and effectively. I would like to hear some of your comments about both the role of the Chief Performance Officer, the Chief Technology Officer, and your Chief Information Officer, and how they are going to intersect. From personal experience, in Virginia when we had enormous budget shortfalls, it was a challenge, but it also allowed us to bring a great number of efficiencies to our system and resulted in us being named best managed state in the country.

We found a lot of those efficiencies, I would add, not only through programmatic review—and I know OMB creates a hit list of programs that perhaps need to be reviewed, but I would just encourage you, as you develop these roles, to think about expanding oversight not just—across government, but particularly in the HR, technology and procurement areas, where I think we could see dramatic savings. I would love to see more emphasis on that.

Mr. ORSZAG. Sure. Let me comment on two aspects of that.

Last week, the President talked about reforms that we will be putting in place to procurement and contracting, so that the cost overruns that I talked about before will be much less likely to occur. The budget includes significant efforts at program integrity; that is, making sure that the right provider or the right person gets the right benefit at the right time, instead of having improper and erroneous payments. And, in fact, we dialed that up as substantially as possible based on hard evidence. There is $50 billion in savings from reducing erroneous payments based on credible evidence about what works and what does not in reducing them embodied in this budget: at HHS, in terms of improper payments to Medicare providers; at the Social Security Administration; in the Tax Code. And I think that is exactly what we need to be doing.

In addition, the Recovery Act clearly raises a challenge in terms of spending the money not only quickly but wisely. We have already put up online Recovery.gov where there will be significant transparency provided; appointed a head of the Oversight Board, Earl Devaney, who is well known for being a very tough Inspector General; and are working actively not only with Cabinet Secretaries but with Governors and others to make sure this money is spent wisely and well in addition to quickly.

Senator WARNER. I would only add, though, that both in terms of ongoing, going forward, I have seen estimates in the past of tens of billions of dollars when we simply rationalize the different technology systems we have, not only across agencies but across secretariats. And if leveraging our purchasing power on the procurement side, not simply in terms of missed payment, but simple business practices, and at moments of crisis, from at least prior experience, you might find a Federal work force that might be more will-

ing to make these kind of systemic changes during these challenging times, No. 1.

No. 2, on the Recovery Act, I know you have appointed a very appropriate Inspector General. My hope would be that their role would not just be to look back, but it would also be a forward-looking process.

Mr. ORSZAG. Absolutely.

Senator WARNER. As you are looking at certain areas like health care IT, which, Senator Whitehouse, is a terribly important area in health care reform, broadband, weatherization of some of the energy projects, projects that have been underfunded in the past, you are going to ask them to ramp up very, very rapidly, trying to bring in and put templates in place on the front end, as well as just common definitions. I know a lot of this is going to be driven around jobs, but if you have got 50 different States all defining job creation in a different way, it could prove to be a problem.

These are areas that I would hope we can just continue a——

Mr. ORSZAG. And let me just—I know we are running out of time. Let me just very briefly point out, the President appointed the person who used to be the Chief Information Officer for the D.C. Government. He now works at OMB as the Chief Information——

Senator WARNER. Prior Virginia Secretary—Assistant Secretary

Mr. ORSZAG. Yes, and he is fabulous. We need to be moving—we have underinvested in IT and IT efficiencies, and we need to be moving much more aggressively so that we are obtaining the benefits that many State governments and city governments have obtained from using information technology more intelligently. We need to do that at the Federal level, too.

Senator WARNER. Mr. Chairman, I simply would love to see this Committee at some future date spend more time on this effort. We may have policy differences. We may have, I think equally on both sides of the aisle, concerns about some of the deficits. But how we truly look at spending dollars more efficiently I think would be the subject of, I know from my standpoint, a great deal of interest, and probably some of the other members.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Warner.

Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman.

Governor Warner—now Senator Warner—like most Governors has to deal with efficiencies and productivities, and they work hard at it, I think generally because they have to have a balanced budget. We do not. But I was Attorney General, and we had a financial crisis, and I saved every dime I could save. I would just say, Senator Warner and Mr. Orszag, you are going to need to personally drive that if you are going to change, because this Congress and no administration since I have been here have the kind of commitment to efficiency and productivity that most Governors have. It is such a big Government, people just do not think that is important, but a few billion here and a few billion there can add up in the long run. And I can assure my colleagues, based on my experience in Government, that we could do a lot better, in my personal opinion.

The example that we set by passing the stimulus package, $800 billion thrown together in a rush-rush manner with very few real amendments and that kind of thing was just stunning. And now we are moving forward with a package with 9,000 earmarks. And you say, "That is OK, we will worry about it next year." That is not a very good answer, I think as the Washington Post replied today, and the editorial yesterday.

We have got to get serious about this spending. The amount of it is just breathtaking. In my opinion, Senator Gregg is just incontestably correct. This budget is more spending, more taxes, and more debt. That is what this budget is. It cannot be defined in any other way. And not just a little bit more spending, more taxes, and more debt. A lot of it in all three categories.

And so I just want to tell you, I am prepared to do some things in this economic crisis and willing to work with the administration. But if, as Senator Gregg alluded, this represents a philosophical commitment by this administration to alter the historic vision of America as a Government of limited Government and lower taxes and free market capitalism, if it is a commitment that results in any significant change in that, count me out.

So let me ask you, doesn't this budget reflect an alteration of a rather significant nature in the classical understanding of the size of the United States Government?

Mr. ORSZAG. No. And, in fact, I mean, while it does represent a change in course, let us look at the revenue proposals. The revenue proposals after 2011 that are generating so much discussion would return the marginal tax rates for the top two marginal tax brackets to the levels that existed in 1993. And at that time, just like now, catastrophe was predicted. If you look at the historical record, anything but is what occurred.

I do not think returning marginal tax rates for the top 5 percent of the population to what existed in 1993, which then kicked off a decade of strong economic performance and strong stock market performance, represents a dramatic——

Senator SESSIONS. Do you think the tax increase kicked off that?

Mr. ORSZAG. The policy changes that were put in place in 1993 helped to encourage economic activity by reducing our out-year deficits and encouraging activity, yes.

Senator SESSIONS. Well, we will have a debate on it, but—and I do not want to go into all at this point. But, of course, the cap-and-trade tax increase is a huge burden on the entire economy also. And some of that money will be given back, but if you look at the budget, I do not think it is expected that all of it will. And as Senator Gregg indicated, we are going to look at no paydown of the debt.

I saw Reuters apparently today had an article that suggested that OMB had not directed or said to the Defense Department that they must delay the replacement of the refueling tanker, the Air Force's No. 1 priority, for quite a number of years, actually. What can you tell us about that?

Mr. ORSZAG. What I can say is we are going to have a more detailed budget in April and that decisions about the tanker—and not only the tanker, but other defense procurement decisions—will be left up to the Defense Department, and in this case the Air Force.

And so the suggestion that somehow OMB dictated or directed this is incorrect.

Senator SESSIONS. Well, what OMB has been known to do is they give you two or three—oh, my time is up—two or three alternatives, none of which are acceptable to the Defense Department, and they have to choose between bad choices and, in effect, it directs something. Is that the nature of this——

Mr. ORSZAG. I think given cost overruns of almost $300 billion in the defense budget, the Defense Department will have lots of options to put itself on a sounder course.

Senator SESSIONS. Well, it is pretty clear to me that the stimulus package did a lot for a lot of different things. It did zero, virtually, for the Defense Department, and I am worried about that direction.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair. And welcome, it is good to have you before the Committee, Mr. Orszag. I must say it is a daunting challenge to lay out a road map to address the Bush legacy of economic disaster, but, nonetheless, you have undertaken that, and I think a superb proposal in which to chart the path out of that disaster, and your emphasis on education and energy and health care, I applaud, while you and the President taking that in your focus on honest accounting as well.

I want to ask you a few detailed questions. One, in terms of the way you envision the option under cap-and-trade, do you envision it as an all-comers option or as an option possibly limited to those participants who need to buy credits in order for their carbon dioxide production? And I ask this question because there was a lot of discussion in the last couple years of how hedge funds, pension funds, and others affected the market in oil futures and drove up the price of oil. Is that something that we can avoid by how we structure this auction?

Mr. ORSZAG. I think a lot of the details of how a cap-and-trade auction system would work remain to be worked out. Is it upstream or downstream? Is it restricted or not?

I would note, though, that to the extent that there are financial markets that exist, even if you do not auction the permits, financial markets can trade in the secondary market, and you would need an appropriate set of regulatory policies to govern the trading, because it is not really a question of whether—I know this came up before. It is not really a question of whether the permits are auctioned or not. It is whether there is secondary trading that occurs, and there will be secondary trading because that helps to provide liquidity to the permit market.

Senator MERKLEY. Thank you. So it is a discussion yet to be had.

Mr. ORSZAG. Yes.

Senator MERKLEY. And details to be worked out.

Also, I wanted to observe that I believe that you use some of the proceeds of the auction to sustain the tax credit for working Americans.

Mr. ORSZAG. Yes, sir.

Senator MERKLEY. And when one takes into account that tax credit as weighed against the higher energy costs, does an average family come out with higher costs or lower costs?

Mr. ORSZAG. Well, it would depend on exactly how this was put in place, but all in all, if you look at the benefits in terms of Pell grants and other benefits provided through the budget, this budget makes the vast majority of Americans better off.

Senator MERKLEY. Thank you. And, third, I wanted to address high-speed rail. I believe there was $8 billion in the stimulus package, then $1 billion a year for 5 years in this budget. That is not a lot of money when it comes to the cost of high-speed rail in that I believe the estimate of building a rail line from San Diego to San Francisco is about $40 billion.

What do you envision being accomplished with this seed money?

Mr. ORSZAG. Well, I would say first the Recovery Act money was a historic investment relative to what has been done so far, and the budget builds upon that. The estimates of how much it will cost depend on what one does, so there are significant differences between the levitation and the very, very high-speed rail, you know, more than 200 miles an hour, versus Acela-like speeds of 125 to, say, 150 miles an hour. The cost is very sensitive to what you mean by high-speed rail.

Senator MERKLEY. Thank you.

That is all my questions, Mr. Chair. Thank you.

Chairman CONRAD. Thank you.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. Having heard the Director this morning in the Finance Committee on health care, I know he is in the middle now of a double header, and I think what I will do is get into a couple of other areas very briefly, starting with taxes.

I think we all understand the Tax Code is going to melt down next year. There have been thousands and thousands of changes to the Code in recent years. It comes now to three for every working day, year in and year out.

The administration has proposed still more changes, particularly in areas of charity and mortgages, and I think my question with respect to taxes is: How does what you are proposing this year on taxes fit into the prospect of tax reform next year when I think there is a real bipartisan possibility of a tax reform bill that broadens the base, cleans out a lot of these special interest perks, and uses that money to hold down rates and keep progressivity? Tell me, if you would, how does the set of tax changes that you are proposing this year fit into the prospects of tax reform next year?

Mr. ORSZAG. Well, just as an example, one of the biggest sets of concerns or loopholes in the Tax Code involves international transactions for corporations. The budget includes $210 billion in that area. One of the biggest issues involves deferral of profits earned abroad. We specifically mention that. There are many other steps that the Treasury Department believes are warranted to clean out that base, as it were, and promote an overall tax reform, which, again, I think I agree with you would be desirable.

Senator WYDEN. I would like to start working with you now, Director Orszag, on that, because I think like health care, it goes

right to the heart of how we are going to grow the economy. I think we understand that economic growth and fixing health care are two sides of the same coin. If you had three sides to a coin, you would probably put tax reform on it, too. So I want to start working with you on that.

Senator Gregg has also done some very good work over the years on tax reform as well.

Let me go now to something that is very important in the Pacific Northwest, and that is the question of funding these programs to fight fire.

Mr. ORSZAG. Yes, sir.

Senator WYDEN. And what has happened there is the previous administration just pushed the Forest Service constantly, almost to the brink of bankruptcy, by refusing to fund the growing cost of wildfire fighting.

Now, to pick up on the Chairman, I brought a couple of charts. The first shows how, since 1991, the fire spending by the agency has eaten up a larger and larger share of the agency's budget. By 2009, it came to 48 percent of the agency's budget. That is in the first chart.

The second chart, which Ms. Miranda has, shows how the Forest Service, when fire spending is removed, has taken the biggest hit of all of the agencies. It comes to a little over 35 percent.

So I would like to pursue with you—and I think what you all did, as with much of the budget, moves in a constructive way because you set up what is, in effect, a contingent reserve account.

Mr. ORSZAG. Correct.

Senator WYDEN. And I think that that is a step in the right direction. But we are still going to end up shorting a lot of these accounts, like Fish and Wildlife and Forest Management. And, frankly, that helps us care for the health of the forests. It helps us reduce the hazardous fuels. It is one of the reasons we will not have to spend so much on fighting fire.

Can I continue to work with you on the question of shoring up these other accounts and what is, in effect, this contingent reserve account?

Mr. ORSZAG. Absolutely, and I was scrambling to find the exact numbers, but the budget includes not only, if my memory is correct, something like $1.5 billion to reflect the average wildfire suppression costs, but also a $300 or $400 million contingent reserve precisely so that other accounts do not need to be robbed in order to address wildfires.

Senator WYDEN. A group of us in the House and the Senate have actually introduced legislation today that calls for a separate wildfire suppression account because of this sort of back-door process of robbing these funds. We want to continue to work with you on it.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Wyden.

Senator FEINGOLD.

Senator FEINGOLD. Thanks, Mr. Chairman. Director Orszag, thank you for being here, and in several ways this budget is a huge improvement over what we have seen over the previous 8 years, in-

cluding the fact that you include a number of important costs that the previous administration simply pretended did not exist.

Having said that, let me ask you a few questions. The President includes some policies in his budget baseline as if they were already the law. I believe the annual hold-harmless patch for the alternative minimum tax is assumed, as is the permanent extension of the 2001 and 2003 tax cuts.

Mr. ORSZAG. That is correct.

Senator FEINGOLD. Rather than including those policy assumptions in the baseline, why didn't the President just include those policies and their cost in his budget request, preferably with other policies that would offset those costs?

Mr. ORSZAG. Well, I understand and respect the baseline that is traditionally—has been used by this Committee. The President feels that that does not conform to a popular understanding of what current policies are. And if you look, for example, at what the Congressional Budget Office did in its long-term projections, when it put forward an alternative fiscal scenario that was intended to capture the thrust of current policy, that is very similar to the baseline that is reflected in the President's budget.

Senator FEINGOLD. Let me switch to something else. The President insisted that the nearly $800 billion stimulus bill be free of earmarks, and I was pleased to see that Congress respected that request. Clearly, the President can have a real impact on this topic.

With that in mind, what other bills will the President insist be free of earmarks?

Mr. ORSZAG. The President feels very strongly that the earmarks need to be reduced even further, and that they need to be much more transparent. I think you are going to see we are actively working with the congressional leadership to come up with an agreement on what to do with regard to earmarks. And I think you will see that coming in the very near future.

Senator FEINGOLD. Well, I hope he goes back to what he did on some occasions with the stimulus bill as saying no earmarks. I would recommend that as a strategy in the future.

If Congress passes legislation giving the President authority to rescind earmark spending along the lines of the line-item veto bill that I introduced recently, will the President sign that bill into law?

Mr. ORSZAG. The President during his campaign spoke about a line-item veto that would need to be done in a constitutionally valid way. Enhanced rescission powers are also a possibility. I would note that even under current law, after passage of legislation, the President can propose a package of rescissions. And so any piece of legislation that is enacted, including the omnibus, can be reviewed by the administration and a package of rescissions can be proposed, which has happened in the past.

Senator FEINGOLD. But would he be inclined to sign a bill that provides for an enhanced rescission/line-item veto approach that he believes is constitutionally permissible?

Mr. ORSZAG. Inclined, yes. Of course, we would have to look at the specifics.

Senator FEINGOLD. Fair enough. I commend the President for committing to use only emergency off-budget funding for the incre-

mental costs of ongoing overseas operations and not for base or ongoing activities, such as security assistance and enhancements to intelligence surveillance and reconnaissance activities. I do not think we should be increasing the deficit to pay for such foreseeable operations or predictable recurring costs. Those items should be included in the regular budget.

With that in mind, what definition of war costs will you be using as you prepare the supplemental for overseas operations? Explain to the Committee how you will draw the line between procurement that should be funded using emergency spending and that which should not?

Mr. ORSZAG. The goal, again, is to—let me back up. Too much of the supplementals that have occurred over the past few years have actually reflected base funding, and we are trying to move that stream of funding into the base budget, as would be more appropriate.

You will see a supplemental, we will be coming to you with a proposal over the next few weeks which is necessary to fund the war, and I think you will see at that point the definition that we are adopting. The budget includes a $75 billion supplemental for the remainder of this fiscal year for the war.

Senator FEINGOLD. Thank you, sir.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Feingold. Thank you, Director Orszag.

A couple of quick things I would like to review with you. It is our understanding that we will have sufficient functional detail from the administration so that we could write a budget during this work period. Is that——

Mr. ORSZAG. That is my understanding also, yes.

Chairman CONRAD [continuing]. Your understanding?

Second, with respect to climate change legislation, this is going to be extraordinarily difficult to accomplish. Tip O'Neill once said, "All politics is local." I represent a State that—most people do not think of North Dakota this way, but we are an energy State. We are a large oil and gas producer. We are a large coal producer. We generate electricity for nine States from the State of North Dakota. Climate change, frankly, in North Dakota would be quite welcome.

I say that—you know, press, do not run out and say that Conrad said climate change would be welcome. That is a joke.

But the reality is I find it unlikely that climate change legislation will pass that does not have some allocations reserved for especially hard-hit industries. You know, I think that is just a reality. And there is increasing talk—I certainly hear it—of the use of reconciliation for the purpose of climate change legislation. I think that has a series of challenges attached to it as well, especially given the Byrd rule. And I hope people are thinking very carefully about how all these things intersect:

No. 1, the effect of the Byrd rule in writing substantive legislation here. We have been told by parliamentary experts that if one tried to write comprehensive legislation using reconciliation, the legislation, once the Byrd rule had been applied, would look like Swiss cheese.

No. 2, if we were to move it in reconciliation, then only a simply majority vote would allow the prevailing side to advance legislation. I think there are an awful lot of Senators who are on the margins on this issue who would be very concerned to see their leverage reduced by that mechanism.

And, third, the notion that there be no allocations for especially hard-hit industries tells me the prospect of succeeding in legislation would be an even more distant hope.

So I hope people are open to understanding that, you know, everybody has their own view, but to accomplish big things takes compromise around here.

That takes me to the question of this budget. What is the White House view with respect to the budget and the committees that have responsibility here? Is there a willingness to have a back-and-forth here to try to get a budget that can pass? Or is it the feeling that we ought to take the budget that has come here and pass it pretty much as is?

I say this because I have colleagues coming to me now every day, every time I go to the floor, another colleague comes and sits down beside me and says, "If this is it, don't count on my vote." I have had enough colleagues now tell me that about enough provisions in this budget to absolutely assure we cannot pass a budget. I gave a speech at noon to our caucus and told them, "Please don't be drawing lines in the sand." I have tried not to draw lines in the sand. I hope the administration is not going to draw lines in the sand.

What can you say with respect to that?

Mr. ORSZAG. Well, let me say a couple things.

First, we had a policy process, and we think that the set of proposals in here reflects our best judgment about the right way of moving forward. I understand that other folks have different ideas, and I hope you know I have a reputation for working with you, and I look forward to doing that.

I would also note, though, the difficulty of wanting to do even more deficit reduction, concerns about some of the revenue proposals, concerns about some of the spending reductions, and how it will all fit together. So, absolutely, I want to work interactively and we want to work interactively with you. I would just come back and say we went through a policy process. This reflects our best judgment, and we look forward to working with you to get to a budget resolution.

Chairman CONRAD. Well, I found interesting reading in the New York Times about reactions to some of our reactions here to the budget. Let me just make very clear from my perspective, we have got an obligation to take what the administration has sent us. We have great respect for it. I have tried to say that publicly. But, you know, we have got a responsibility here, too, and if we do not get the votes, it is kind of an empty exercise. And getting the votes—anybody who thinks it is going to be easy to get the votes on a budget in the conditions that we face is smoking something.

I would add two things. On the question of the limits on deductibility, I have heard from many members concerns about that—the effect on charities, the effect on housing when there is already a

housing downturn. So that has clearly in the budget proposal come up. It is one hot spot area. No doubt you have heard it as well.

Second was on agriculture, and, you know, I represent an agricultural State. I just spent the last year and a half getting a farm bill passed, and we paid for the farm bill. We paid for the farm bill. But precious little else is paid for around here, and I was a little taken aback to read that people are suggesting somehow the farm bill was not financially responsible or fiscally responsible, because of all the things that have occurred around here in the last 2 years, one of the very few that was actually paid for—and it was done at my insistence—the farm bill was paid for. So we made a lot of tough choices. We raised money. We made spending reductions.

And so those who suggest it was not fiscally responsible, I do not think they are very aware of the history of how we got a farm bill passed here with 81 votes, overcoming two Presidential vetoes, and reopening that at this moment is probably not a real propitious way to advance this budget.

With that, I would call on my colleague.

Senator GREGG. Thank you, Mr. Chairman.

You did not ask the question, so I will ask it: Does the administration support the use of reconciliation relative to the carbon tax, also known as a national sales tax on energy?

Mr. ORSZAG. What we have said with regard to both health care and energy is that we would prefer not to start there. But we are not taking anything off the table at this point.

Senator GREGG. Well, I would just make the point that reconciliation is a very unique vehicle. I do not recall in my experience—and I think that reconciliation has been used most aggressively during the period that I have had the chance to serve in the Congress, so I think I have been there for the big reconciliation events—that it has ever been used on an issue that is ab initio of the size of the national sales tax on energy, or on an issue that is as all-encompassing and as complex as health care.

It has, obviously, been used aggressively—aggressively on a lot of authorization bills, a lot of authorizing areas, and 2 years ago it was used very aggressively in the student loan area, which I would represent is one of the reasons why the private sector is not necessarily doing so well on student loans. And it has obviously been used on tax policy, but not on rewriting the entire tax laws. That was done in an open-field event in the 1986 act.

So to initiate a reconciliation effort in the area where you are basically creating a brand-new, massive exercise in an attempt to address global warming, with a carbon tax and cap-and-trade and all the different ramifications of that, would be, I believe, to depart from the purposes of reconciliation and create real consternation, if not outright—well, it would be an act of violence against the system here in the Senate, in my opinion, of open debate. And you probably are not going to get to where you want to go if you did that. I do not think you can do it on health care, anyway, because of all the Byrd rule issues. But I am not so sure about the carbon tax.

So I think the fact that the administration has not taken that off the table probably undermines the ability to draw in people like Senator Alexander and myself, and Senator Graham, who have all

been sponsors in the past of initiatives in the area of limiting emissions, because we will be concerned that if we step into this exercise, we will be blindsided with a reconciliation exercise. And there is no point in stepping into the exercise if we are going to be shut down in our ability to influence it. So I think that is a concern—not that you really care.

On the issue of——

Mr. ORSZAG. I do care, but OK.

Senator GREGG. On the issue of the budget, I am entertained by the fact that we are not going to get the specifics of the budget until after we pass the budget. You parried a number of questions from my colleagues on the other side with the statement, "Well, when we send up the real budget in April, we will have more specifics on that." By the time you send up the real budget in April, we will have passed the budget.

Mr. ORSZAG. As you know, it is normal during a transition year to put forward an overview like we have done. You have 6 weeks to put together something that normally takes 6 months, and then to followup with a more detailed budget thereafter, that is exactly what has happened during past transitions also.

Senator GREGG. Do you then expect that your serious budget with the serious detail is going to come to the Congress after the Senate has voted on its budget and the House has voted on its——

Mr. ORSZAG. Let us be clear about what you are filling in. You are filling in below the top lines for each agency the detailed appropriations that——

Senator GREGG. Well, you are putting in enough so that you could not answer questions here today that were asked. There were three questions asked——

Mr. ORSZAG. One was on tankers—what were the other questions that I could not answer?

Senator GREGG. There were three of them—and I have forgotten the specifics—on the issues, and you said, well, when we get the budget——

Mr. ORSZAG. I think they all were with regard to sub-total discretionary questions, which are decided as part of the appropriations process later in the year.

Senator GREGG. So you expect your——

Mr. ORSZAG. We have provided the top lines in the functional numbers that you need to write a budget resolution.

Senator GREGG. But the detail is not going to come until after the budget resolutions are voted on.

Mr. ORSZAG. But the budget resolutions do not govern that sub-detail. So, in other words, we are providing the level of detail——

Senator GREGG. You do not think when a budget goes to the floor of the Senate that there is not a lot of discussion about what the detail of those gross numbers is?

Mr. ORSZAG. I will defer to this Committee's judgment, but I believe this is exactly what always happens during a transition year, and we are providing the information you need to write a budget resolution.

Senator GREGG. Well, that may be, but I would think that it would be incomplete if you are not going to put the meat on the bone before we have the votes on the issue.

You said you support rescission, and you have the authority for rescission, so in the omnibus which we are about to vote on right now, what will you—will you be sending up rescissions relative to earmarks?

Mr. ORSZAG. The normal process is to have legislation enacted. The administration then has the ability to propose a set of rescissions, and so at the appropriate time, we can come back to you, if it is appropriate, with a package of rescissions.

Senator GREGG. Well, since the majority—and it has the right to do this—is not allowing any amendments to this package to pass—they are allowing us to offer them, and I greatly appreciate that courtesy, and I think it is appropriate. But they have got the votes to stop them. So we know what the form of the omnibus is, and you have known it for a while since you helped write it. And, therefore, my question would be——

Mr. ORSZAG. Well, I did not—the administration has not been involved in writing the omnibus at all, period. And, in fact, I want to emphasize this. There have been Cabinet Secretaries who have wanted to come up to the Hill to ask for this or that as part of the omnibus. The administration has not been involved in writing this omnibus legislation. It was largely done last fall, and that is what it is.

Senator GREGG. Well, it was not largely done last fall. The add-ons occurred between last fall and now. It occurred since you have taken office. But let us accept the fact that you were not involved in writing those add-ons, but you have had a chance to read it, because it has existed for a while. It passed the House. It is going to pass the Senate. Is there nothing in this bill that is going—as it has passed the House and is going to pass the Senate today, that you will send—that you can tell us today you are going to send a rescission up on?

Mr. ORSZAG. Again, I want to allow the legislation to be enacted. We will then review it as enacted, and if it is appropriate, we will be proposing, as the President is allowed to do, a package of rescissions, which the Congress can then——

Senator GREGG. The President has said he is opposed to earmarks. There are 9,000 earmarks in this bill. Could we presume that the President will send a rescission package up covering five of those?

Mr. ORSZAG. I do not want to get in this game of presumption, but, again, you are correct that the level of earmarks in this legislation is higher than the President would have liked.

Senator GREGG. Thank you. I appreciate your time.

Mr. ORSZAG. Thank you, sir.

Chairman CONRAD. Thank you. Thank you, Director Orszag. Thanks for your service. Thanks for your extraordinary hard work coming into an incredibly challenging environment and doing a very professional job. We appreciate it.

We will stand adjourned.

[Whereupon, at 4:20 p.m., the Committee was adjourned.]

Michael B. Enzi

Statement for the Record

from Senator Michael B. Enzi (R-WY)

"The President's Fiscal Year 2010 Budget Proposal"

03/10/09

Senate Committee on the Budget

Thank you Mr. Chairman, and Dr. Orszag welcome back to the committee. I don't have a lot of time so I'm going to jump right in.

Although there are several aspects of this budget that merit serious debate, I take issue with two provisions in particular:

(1) The increase in the top two individual tax rates which would have a profound impact on small business, and

(2) The proposed policy shift in the Abandoned Mine Land (AML) trust fund.

The White House has said repeatedly that 97 percent of small businesses will see no tax increase in this budget, and when you look at the data based on the number of filers affected by rate change, you may have a point.

But that's because your data is skewed by the number of one- and two-job filers with business pass-through income. In your statement, an s-corporation with 250 employees is treated the same as a hobbyist selling collectibles part-time over EBay. But I think we can all agree that the economic impact of raising taxes on the 250-employee s-corporation is more significant than the economic impact of a tax cut for the single hobbyist. A tax increase on the s-corporation will ripple through the company affecting jobs, wages and supply chains.

The fact is, when you look at the proposed increase in the marginal rates from a jobs and income perspective, the economic impact is very large and very real:

- According to 2007 Treasury Department statistics, pass-through income represents one-third of all business income.
- Over 70 percent of this income is concentrated in the top two rates.
- Thus roughly one-quarter of all business income would be subject to higher taxes under the Administration's plan.
- Moreover, a Gallup survey commissioned by the National Federation of

> Independent Businesses reveals that half of the businesses that employ between 20-249 employees will be affected by the increase in the marginal rates.

So to say that only 3 percent of filers would be affected by the tax increase isn't kosher – it's just a marketing ploy to obscure the real and potentially hurtful economic impact of the tax increase.

If you want to throw all statistics out the window entirely, this tax increase is STILL a bad idea. If marginal rates are allowed to rise, the income earned by small businesses and entrepreneurs – the economic engines of our economy – will be subject to higher tax rates than our domestic corporations. How is that good tax policy? How is that good economic policy?

Second, I'm extremely disappointed with the provision in the President's budget regarding the Abandoned Mine Land (AML) trust fund. For years, money that should have been going to states was kept in the federal Treasury for unrelated programs and budget gimmicks. The program wasn't working for anyone and so we fixed it.

I was one of the lead authors on a carefully constructed compromise that reauthorized the AML Trust Fund in 2006. That trust fund continued the tax on coal companies for each ton of coal they mine, but made sure that the money went where it was intended – to clean up abandoned mines and to help the states where that mining took place.

Our compromise legislation included Democrats and Republicans. The coal industry and the United Mine Workers of America supported the bill. Members from certified states like Wyoming supported the compromise as did members from uncertified states like Pennsylvania and West Virginia. As a Senator, President Obama voted in favor of legislation that included this agreement.

Rather than reneging on this promise, I hope the Administration can work with lawmakers to preserve this carefully crafted compromise.

March 9, 2009

The Honorable Kent Conrad
Chairman
Senate Committee on the Budget
624 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Judd Gregg
Ranking Minority Member
Senate Committee on the Budget
624 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable John M. Spratt, Jr.
Chairman
House Committee on the Budget
207 Cannon House Office Building
Washington, D.C. 20515

The Honorable Paul Ryan
Ranking Minority Member
House Committee on the Budget
207 Cannon House Office Building
Washington, D.C. 20515

Dear Senator Conrad, Senator Gregg, Representative Spratt and Representative Ryan:

We are writing to express our strong support for including in the budget resolution the resources needed to enact comprehensive health reform legislation. In our view, such legislation should include effective provisions to reduce costs by improving the quality and efficiency of health care and help ensure coverage for every American.

Legislation of this kind will reduce the rate of growth of both federal and private health care expenditures, and will thus improve the fiscal health of the nation. While the cost savings from improving the efficiency and quality of health care will be significant, many of the anticipated savings will be realized in the long term, and may thus not be evident in a ten year budget window. Moreover, CBO's current scoring conventions do not recognize many of the savings to be achieved by a restructuring of the health care system.

We believe, therefore, that it would be reasonable to develop an approach for health care reform that reflects both the near-term exigencies and long-term savings of such extraordinary legislation. Requiring spending or revenue offsets for the entire cost of health reform within a ten year budget window, as required under a traditional pay-as-you-go rule, will significantly reduce the likelihood of enacting legislation to achieve essential reforms for long-term savings.

We therefore request that the committee develop a more flexible approach to pay-as-you-go for health care reform that reaffirms the importance of offsets but accommodates the need for significant short-term expenditures that will help set the health system on a path toward significant long-term savings and improvement in the long-run fiscal future of our country.

We commend you for your strong support of health reform, and look forward to working with you on this important national priority.

AARP
AdvaMed
Aetna
AFL-CIO
America's Health Insurance Plans
American Benefits Council
American Cancer Society Cancer Action Network
American College of Physicians
American College of Surgeons
American Diabetes Association
American Hospital Association
American Medical Assocation
American Osteopathic Association
Blue Cross Blue Shield Association
Business Roundtable
Catholic Health Association of the United States
Consortium for Citizens with Disabilities – Health Task Force
Families USA
Federation of American Hospitals
Leadership Conference on Civil Rights
National Association of Children's Hospitals
National Association of Community Health Centers
National Association of Public Hospitals and Health Systems
National Federation of Independent Business
National Medical Association
National Partnership for Women & Families
National Retail Federation
PhRMA
SEIU
U.S. Chamber of Commerce

OMB Director Peter R. Orszag, Responses to Questions for the Record from Senator Bunning (Senate Budget Committee hearing, March 10, 2009)

1. FFEL proposal, increase in debt

Annual student loan volume is roughly $80 billion and growing. The vast majority of new loans have traditionally been financed in the private capital markets. Wouldn't the Treasury need to issue hundreds of billions of dollars of additional debt in the coming years if it were to make all new loans directly?

Response

In response to Federal Family Education Loan (FFEL) program lender concerns about insufficient capital to make student loans, Congress and the Department of Education established emergency programs that allowed FFEL lenders to essentially finance a significant portion of their loans through the U.S. government. Between these programs and the Direct Loan program, over 75 percent of all Federal student loans originated in the 2008-2009 school year were done so with funds from the Treasury. Under the Administration's proposal, all Federal student loans would be originated through the Direct Loan program and financed by the Treasury up front. While this would increase near-term borrowing, the Administration's proposal would produce significant budgetary savings, and thus reduce the overall debt in the long run.

2. FFEL proposal, interest rates

Isn't the projected savings from this proposal essentially due to the fact that it leverages the current low-cost of Treasury debt? If Treasury rates rise unexpectedly due to the rapidly spiraling debt couldn't that sharply reduce the projected cost savings of this proposal?

Response

The Administration was careful when it developed its FFEL savings estimates to account for the program's sensitivity to changes in interest rates, as well as the probability that interest rates could fluctuate in future years. The approach we took in the treatment of these rates is similar to the approach taken by CBO in its FFEL estimates. Our savings estimates, therefore, are robust to almost any realistic set of interest rate assumptions; even if Treasury rates and Commercial Paper rates return to their historical average, eliminating FFEL subsidies and ramping up the Direct Loan program will continue to generate savings for taxpayers.

3. FFEL proposal, job losses

Has the Administration done an analysis to project how many thousands of jobs will be lost with the private-sector based student loan program, and where those jobs are currently located?

Response

The Administration has not conducted such an analysis, but we are already working with the FFEL community to give them a significant role in the future of the program through DL origination and servicing activities that will need to performed and done in volumes larger than ever before. We are anticipating a robust market for these services to be provided by multiple firms involved in the current FFEL program. Moreover, even when the Administration's proposal is adopted, FFEL lenders will continue to originate private student loans and other loans as parts of their existing lines of business.

4. FFEL proposal, ED servicing costs

Can we assume that the projected cost-savings of moving to direct lending do not include the life-of-loan cost of servicing for all new loans that would become the responsibility of the Federal Government? Such costs are currently folded into the subsidy rate of FFEL loans but not the subsidy rate for direct loans. Direct loan servicing costs are paid out of a separate annually discretionary spending account of the Education Department. Wouldn't annual appropriations to this account need to surge to cover the cost of servicing a growing portfolio of student loans, each of which can remain outstanding for as long as thirty years or more?

Response

Though the projected savings presented in the FY 2010 Budget from moving to 100 percent direct loans does not include the costs of life-of-loan servicing, these additional costs will be presented in the Appendix. On balance, even with these additional administrative costs, originating all Federal student loans through the Direct Loan program would still result in significant taxpayer savings.

OMB Director Peter R. Orszag, Responses to Questions for the Record from Senator Conrad (Senate Budget Committee hearing, March 10, 2009)

1. Public broadcasting

Public broadcasting is funded as two-year advance appropriation, which currently amounts to $400 million a year. However, the nation's economic crisis has created a difficult financial situation in public broadcasting. I'm told that the country's public broadcasting stations face a revenue shortfall of more than $300 million in 2010 and may have to lay-off employees. Is the Administration aware of this issue and do you have plans to address the concerns of public broadcasting station leaders?

Response

The Administration recognizes and supports the role of public broadcasters in providing public service media. The enacted advance appropriations for the Corporation for Public Broadcasting (CPB) of $420 million in 2010 and $430 million in 2011 will provide some stability to the public broadcasting system. The Budget also includes additional budget-year funding for CPB for 2010 to support system investments, as well as an advance appropriation for 2012 to support base operations. The Administration believes that broad support by government and the private and non-profit sectors has helped public broadcasters serve their communities effectively, and we are continuing to work with CPB to understand their resource needs and how they are affected by the current economic climate.

OMB Director Peter R. Orszag, Responses to Questions for the Record from Senator Crapo (Senate Budget Committee hearing, March 10, 2009)

1. Potato Cyst Nematode eradication

As you know from our previous discussions about this issue, since the Potato Cyst Nematode (PCN) discovery three years ago, approximately $30 million has been invested in our efforts to eradicate PCN. The Animals and Plant Health Inspection Service (AHIS) Potato Cyst Nematode eradication program has made significant progress in the eradication effort, and we have a chance of purring significant progress in the eradication effort through, and continued dedication of funding is paramount to this effort. It is estimated that $13.5 million will be necessary to adequately fund these efforts for FY2010. Are you committed to fully funding the continuing Potato Cyst Nematode eradication effort in Idaho in the President's FY2010 Budget?

Response

The Administration recognizes the seriousness of the threat of potato cyst nematode. The Federal government has provided significant support for this program in the past. We will continue to support the program in the FY 2010 Budget.

2. Cap and trade, impact on families

I am concerned about the cap-and-trade proposal outlined in the President's budget and the costs it will have on the American taxpayer.

The President's budget predicts that a cap-and-trade program would reap $79 billion in revenue beginning in 2012, increasing incrementally over the next few years to $83 billion in 2019. The outline predicts that the total revenue raised between the 2012 enactment through 2019 would be $646 billion. EPA estimated that the Lieberman Warner Climate Security Act, which had much less stringent emission caps, would have cost families at least $4,400 per year in increased energy costs.

The President has decided to use 80 percent of revenues from the auctions to provide a tax credit to families that qualify. How much would this tax credit be worth to families that do qualify (because not all families qualify), and isn't there still a major disparity between the tax credit and the amount families will have to pay in increased energy costs?

Response

The impact on household consumption that you cite is distinct from changes in energy costs, and is largely determined by the provisions in the legislation that govern the amount of revenues returned to the public. As EPA stated in its analysis, "if auction revenues were used to lower distortionary taxes, the costs of the policy would be lower." The cap and trade proposal described in the Budget would return the majority of revenue

to vulnerable families, communities, and businesses to ease the transition to a clean energy future. As the details of the cap and trade legislation take shape through our work with Congress, we will use economic models and other information to inform the most effective and balanced approach.

The climate change revenue estimate in the Budget is a conservative placeholder projection until legislation is more fully developed. Actual revenue will be more than sufficient to fund $15 billion per year towards a clean energy future and make permanent the $800 "Making Work Pay" tax cut for workers and their families, which will apply to about 95 percent of all American workers. Any additional revenue will be returned to the public to help them make the transition to clean energy. Consequently, we do not believe there is a major disparity between the tax credit and the increase in energy costs, and furthermore we will not allow struggling Americans to become overburdened with their electric and heating bills. We believe a market-based approach will spur American ingenuity and entrepreneurship to find the least expensive means to bring clean energy sources online. Furthermore, through the Recovery Act we are already making a significant down payment to weatherize homes that will help keep energy bills affordable for low-income families.

3. Yucca Mountain

Despite the lack of detail in the Department of Energy's FY2010 budget it appears clear that the Yucca Mountain project will take a severe funding hit this year. Every year we delay opening the Yucca Mountain facility we add a further $500 million in liabilities to the U.S. government and we make it clear to communities like those of my home town in Idaho Falls that we have no intention of meeting our Federal commitments. If Yucca Mountain is off the table, then what is the Administration's plan B for the safe disposal of spent nuclear fuel and high level waste?

Response

The Administration will engage in a policy process to explore the proper means for safe and secure isolation of the nation's nuclear waste. It is not clear in advance that the projected costs of the government's nuclear waste storage liabilities for alternatives will exceed those previously anticipated for Yucca Mountain, including any potential liabilities. The Administration anticipates ample opportunity for Congressional and other input.

4. Transportation contract authority

I'd like to discuss transportation program contract authority. Page 92 of the budget document proposes to change the budgetary treatment of contract authority from mandatory to discretionary. The bipartisan leadership of the transportation authorizing committees in the Senate and the House strongly objected to this.

The submission from the Administration says that this scoring change would help ensure more "transparent" budget presentations.

Let me say that I never found the current way we score contract authority to be an obstacle to understanding the budget.

So, if there is no important transparency issue, the question is whether there would be substantive consequences if this proposal were to be adopted.

For example, are you proposing to change the legal status of contract authority, so that a contract authority dollar is of no more value than a dollar of authorization in a non-trust funded program? That does not seem proper given that highway users, for example, pay into a trust fund expecting there to be some trust in the trust fund, some assurance that the funds will be invested as intended. This seems to weaken the policy commitment to infrastructure investment.

I have two questions about this issue: First, completely apart from transparency, what substantive and policy consequences do you think would result if this change in scoring contract authority were to happen? Second, wouldn't this change weaken the trust fund concept and, as a result, make it a harder to fund transportation infrastructure?

Response

The scoring change in the Administration's FY 2010 Budget is not meant to change the substance or policies relating to Federal transportation programs, nor is it intended to present a specific reauthorization policy or change how programs are currently executed. Procedurally, the authorizing committees would continue to write bills that provide contract authority, which would continue to have same legal meaning, and the appropriators would continue to provide an obligation limitation. However, the scoring change would assign the budget authority score to the appropriators to reflect that the obligation limitation effectively represents the level of resources available to the program in that fiscal year.

We do not believe that scoring change would make it harder to fund transportation infrastructure. It is meant to make the budgetary costs of transportation programs more transparent. In the context of highways, the current challenge to the trust fund concept is the imbalance between revenues and spending: highway user fee revenues cannot support authorized spending levels in the near or longer-term. We look forward to working with the Congress to develop fiscally responsible long-term solutions for addressing this issue.

5. Capital gains rates and investment

This budget proposes to allow the tax rates on capital gains and dividends to rise from 15% to 20% in 2011 for individuals making more than $200,000 and couples making more than $250,000. First, I would like to echo the concerns that many have raised after reading this budget, that we should not be raising taxes on anyone during a recession. In

response, I know you have said that these tax increases will not take effect until 2011, when you project our economy will be in recovery. But when you talk about tax rate on long term investments, like the capital gains rate, doesn't an announcement today that the rate will be going up in less than two years have the same effect as increasing taxes today? One of the main difficulties we are facing in this current economic crisis is that there is so much uncertainty that individuals and businesses are keeping their money on the sidelines, rather than making investments now. An individual who might be considering making a long-term investment today isn't so much concerned about what the capital gains rate is today, they are concerned about what the tax rate will be 2 years from now, or 5 years from now, when those long-term investments are hopefully yielding gains. As such, doesn't the President's proposal that, for some individuals and couples, their capital gains rate will be going up in 2011 serve as a disincentive for those individuals and couples to make investments now? And won't they instead be more inclined to continue to keep their money on the sidelines instead of putting it into the economy?

Response

The predominant concerns among investors are when the economy will turn around and business profits begin to increase. Those expectations are much more important for the performance of the markets than the potential changes in capital gains taxes two years from now. Our program is designed to restore confidence in the financial sector, provide tax relief to the middle-class and small businesses, and undertake long-term investments in health, energy, and the environment that will strengthen our economy in the long run. If we are successful in these endeavors, the markets will react favorably.

OMB Director Peter R. Orszag, Responses to Questions for the Record from Senator Enzi (Senate Budget Committee hearing, March 10, 2009)

1. Tax increase on small business

The resilience of the US economy and its ability to recover from an economic crisis like the one we now inhabit is directly related to the vitality and flexibility of our non-corporate sector. Creating and protecting a business environment that is conducive to entrepreneurship and the exploration of new ideas is what made our nation great – and which will propel our economy out of this crisis. There is bipartisan concern in both chambers over the impact of these tax increases on small business. Would the Administration support an effort to protect small business by "carving" them out from the impact of this tax increase?

Response

Most owners of small businesses will pay lower taxes as a result of the Economic Recovery Act and the initiatives proposed in President's FY 2010 Budget. The Tax Policy Center estimates that only 2 percent of filers who have more than 50 percent of their income from a small business will have higher taxes.

The Recovery Act extended for one year the temporary increase in limitation on expensing, which is kept at $250,000 through 2009. Other business tax relief in the bill may also apply to small businesses. In addition, the Budget proposes to eliminate capital gains on small businesses and start ups.

Nearly all small business owners with income of less than $250,000 that report their net business income on Schedule C (e.g., not corporations or partnerships) will receive tax cuts if the Budget initiatives are adopted, as they will benefit from extension of middle class tax cuts and other provisions. Only small business owners with income over $250,000 have the potential for tax increases -- but in most cases this would not occur until at least 2011.

2. Delaying tax increases

The Administration has been quick to explain that the proposed tax increases would occur only after the economy has rebounded. The economic assumptions underpinning this budget suggest you think this would be January of 2011, but no one can be sure and your economic assumptions have been criticized as being more optimistic than most. To ensure that these tax increases do not take effect when the economy remains soft, would you instead support a policy tying the effective date of the tax increases to a substantial and sustained improvement in the unemployment rate?

Response

The Administration expects the economy to begin to pull out of recession later this year and experience a strong rebound in 2010 and 2011. Some forecasters expect a further delay in the recovery, but most still see an expansion occurring by the middle of next year. By 2011, the limited tax increases on the wealthy proposed in the Budget will not have an adverse impact on the strength of the recovery, and we have accounted for those tax changes when making our economic assumptions.

These assumptions and the Administration's proposals will be adjusted in future years to reflect existing conditions in the economy. That will affect both spending and revenue proposals. But there is no reason now not to delay these proposals just because the economy may be worse, or better, than we anticipated.

3. AML trust fund proposal

On Page 79 of the President's budget, which is part of the Department of the Interior's Budget proposal, there is a heading titled "Provide a better return to taxpayers for mineral development." I take objection to the heading, but even more distressing than the heading is that the bullet point that reads, "Terminating payments to coal-producing States that no longer need funds to clean up abandoned coal mines."

I was one of the lead authors on a carefully constructed compromise that reauthorized the Abandoned Mine Lands Trust Fund in 2006. That trust fund continued the tax on coal companies for each ton of coal they mine. The compromise legislation included Democrats and Republicans. The coal industry and the United Mine Workers of America supported the bill. Members from certified states like Wyoming supported the compromise as did members from uncertified states like Pennsylvania and West Virginia. As a Senator, President Obama voted in favor of the legislation that included this compromise.

The bullet point that proposes terminating funds to some states gives very little detail about the Administration's plan. If the Administration proposes terminating funding from states, will they also propose eliminating the tax that coal producers pay in those states so that the state's can levy a new tax to make up for lost revenue?

Response

The Budget retains the existing coal fee that funds the Abandoned Mine Lands (AML) program and the AML payments to States that still have abandoned coal mines to clean up. The fee on coal producers is still needed to reclaim abandoned coal mines, regardless of where the abandoned mines or coal producers are located.

The Budget proposes to eliminate the unrestricted payments directly from the Treasury to "certified" States (i.e., states that have already completed their coal reclamation

projects). Additional details on the implementation of this proposal are being developed and will be released shortly.

4. Project labor agreement EO

I was very disappointed that one of President Obama's first executive orders reverses the Bush policy of neutrality on government contracts, and instead encourages agencies to require their private contractors to engage in collective bargaining agreements on contracts of $25 million or more. The President also directed OMB to review whether this project labor agreement (PLA) preference should be required even more broadly and report back within 180 days. In my view this policy discriminates against small and local contractors and needlessly drives up costs for taxpayers. Are you planning to recommend that the $25 million threshold be lowered?

Response

As you note, the Executive Order tasks OMB with providing, within 180 days, recommendations about whether broader use of project labor agreements would "help to promote the economical, efficient, and timely completion of such projects." OMB's recommendations, which are due in early August, are under development.

5. Davis Bacon and Recovery Act

The Stimulus bill extended Davis Bacon prevailing wage requirements to every project contracted and subcontracted under the bill. By most estimates, Davis Bacon causes such projects to cost significantly more than the fair market price. Beyond the extraordinary government waste which the Davis Bacon Act mandates, its application has a particularly objectionable effects in the context of an economic stimulus bill. First, simple mathematics makes it clear that if you are paying labor costs that are artificially inflated over the actual market cost for labor then you wind up providing less work for fewer workers. Second, the red tape and administrative costs associated with Davis Bacon have the demonstrable effect of shutting small and minority contractors out of these construction projects. In this time of deficits which seam frankly unpayable, why is this Administration's policy that taxpayers should pay more than everyone else for a service?

Response

The Administration supports Congress' decision to apply the Davis-Bacon Act to construction projects financed with Recovery Act dollars. The Davis-Bacon Act protects American workers by preventing Federal contractors from using their leverage to lower local construction wage standards.

6. Extended UI trigger

The President's Budget projects making changes to the trigger mechanism to determine when states qualify for the Extended Benefits program. Can you explain what changes

the Administration is proposing? In the stimulus bill the cost burden of unemployment benefits was significantly shifted from a joint state and Federal venture to primarily Federal. Does the Administration have any plans to avoid shifting these costs back to the states in 2010?

Response

The detailed Budget the Administration will publish in early May will contain additional information on this proposal.

7. Department of Labor funding

The President's Budget purports to boost funding for OSHA, Wage and Hour, and the Office of Federal Compliance Programs. What kind of funding increases has the Administration planned and will this be funded by entirely new spending or do you plan to decrease funding for other DOL functions? If you are planning decreases, are you contemplating cuts to compliance assurance programs and the Office of Labor and Management Standards?

Response

The Administration is fully committed to ensuring that every American worker has safe, healthful, and fair working conditions. The President's 2010 Budget seeks to restore the Department of Labor's ability to vigorously enforce the more than 180 laws that protect working Americans, and increases funding for the Occupational Safety and Health Administration and the Employment Standards Administration. The detailed Budget the Administration will publish in early May will contain additional information on these proposals.

8. Pell CPI indexing

In this period of economic uncertainty, how can OMB predict the budgetary impact of tying Pell to CPI +1%?

Response

All future cost projections are estimates, and the cost of the Pell program is based on the same economic assumptions used for estimating costs in the rest of the Budget. CBO follows a similar process.

9. FFEL/DL administrative costs

Even in this time of economic uncertainty, the FFEL program has successfully delivered $50 billion in capital to students. What additional administrative cost will be incurred by the Department of Education (over 1, 5 and 10 years) in moving the entirety of this annual loan volume to the Department, and servicing those loans in years to come?

Response

In response to the time of economic uncertainty and Federal Family Education Loan (FFEL) program lender concerns about insufficient capital to make student loans, Congress and the Department of Education established emergency programs that allowed FFEL lenders to essentially finance a significant portion of their loans through the U.S. government. Between these programs and the Direct Loan program, over 75 percent of all Federal student loans originated in the 2008-2009 school year were done so with funds from the Treasury.

We are developing detailed cost estimates of the Department of Education's administrative expenses in both programs, including future projections that will be included in the detailed 2010 Budget. Those details will be available when the complete budget document is released. However, even after accounting for these administrative costs, eliminating FFEL and expanding the Direct Loan program still realizes significant taxpayer savings.

10. DL loan forgiveness

A number of unique loan forgiveness benefits apply to the Direct Loan Program. How will tripling the volume of loans originated in the Direct Loan program affect the cost of these benefits over 1, 5 and 10 years?

Response

The only loan forgiveness benefit available through the Direct Loan Program that is not available through FFEL is loan forgiveness for public service. In this case, qualifying FFEL borrowers can already access the program through a Direct Consolidation Loan. Other benefits, such as teacher loan forgiveness, are available in both programs. As a result, shifting new volume to Direct Loans should have little impact on loan forgiveness costs.

11. Treasury role in student loans

While the Department of Education has administered the DL and FFEL programs for a number of years, there is significant technical expertise in the intricacies of leveraging Federal capital in support of public policy at the Department of Treasury. Has your office considered moving the student loan programs to the Department of Treasury? Would co-locating the student loan programs in the same Department as the Internal Revenue Service ease the process of allowing for pre-production of the FAFSA with tax information?

Response

Treasury does not currently have the capabilities to service this volume of loans to individuals. The Department of Education has a complete life-of-loan servicing

capability and long-standing relationships with student and schools. Transferring the student loan programs to the Department of Treasury would require building a new servicing structure to replace one that is fully functional and familiar to schools and students. In addition, the Department of Education provides other vital student aid, such as Pell grants, that are packaged with student loans. Separating loans from other programs would create needless complexity for schools, students and parents.

However, the Department of Education works closely with the Department of Treasury to utilize its technical expertise on issues. For instance, the Department of Education and Treasury are already working on establishing systems to allow sharing of student income data for the purposes of determining aid and streamlining the FAFSA process. The Department also consults with Treasury on implementation of the Ensuring Continued Access to Student Loans Act.

12. College persistence program

The Higher Education Opportunity Act created a Pilot Program to Increase College Persistence and Success. To what extent may that program serve as the vehicle for your office's interest in expanding efforts to incentivize college completion?

Response

Pilot Programs to Increase College Persistence and Success is an attempt to address the same problems that our budget proposal tackles. Under the program authorized in the Higher Education Opportunity Act, the Secretary would award competitive grants to institutions of higher education that provide a one- or two-year program of study leading to a degree or certificate to develop and evaluate programs to increase the persistence and degree or certificate completion of low-income students.

The proposed College Access and Completion Fund would instead provide grants to States to design, test and bring to scale strategies to increase persistence and program completion. The use of States as intermediaries in this program will foster innovation and competition, as States are best able to identify the right institutions and populations to target. As a result, States will have significant flexibility in using these funds to test strategies, using rigorous research designs that show promise. Once shown effective, these promising practices can be taken to scale within a State. Additionally, a portion of these funds will be used to support educational activities (such as financial literacy) currently provided by State guaranty agencies participating in the FFEL program.

13. Cost of saver's credit and auto-IRAs

Please provide the 1, 5 and 10 year cost of the administration proposal to expand the Saver's Credit. Please provide the 1, 5 and 10 year cost of the administration's automatic enrollment in IRAs and 401(k)s proposal.

Response

Automatic workplace pensions would help workers overcome the inertia that often keeps them from participating in employer-sponsored plans. Employers not offering plans would be required to enroll employees in a new system of direct-deposit IRA accounts. Employees would always have the option of choosing to opt out.

An expanded and refundable Saver's Credit would increase saving among middle- and low-income families. Current tax incentives for saving primarily benefit high-wage workers. The expanded Saver's Credit would address this inequity by matching 50 percent of the first $1,000 of savings for families earning less than $65,000, with the credit then phased out for families with higher incomes

Today many workers approach retirement with little or no financial savings and roughly half the workforce – 75 million working Americans – lack employer-based retirement plans. The Administration proposes to expand the Saver's Credit and establish a system of automatic workplace pensions that would dramatically increase the number of Americans saving for retirement.

The Administration estimates that the two proposals would cost about $14 billion through 2014 and $55 billion through 2019. Year-by-year estimates are in Table S-6 of the FY 2010 Budget (p. 122). The Administration looks forward to working closely with Congress to enact these proposals.

14. Health reserve fund

This budget establishes a $634 billion reserve fund as a "down payment" for health care reform. If $634 billion is a down payment, how much more do you expect health care reform will cost? I'm also curious how you got to this number – can you provide some details? Also, the number is so specific that it suggests to me that you have a proposal upon which the number is based – can you confirm this? I was under the impression the President was relying on Congress to send him a bill rather than developing his own proposal. Is this still true?

Response

The Administration continues to look forward to developing a health reform approach through an open and inclusive process that explores all serious ideas that achieve the common goals of constraining costs, expanding coverage, and improving quality. To help finance comprehensive health care reform, the President's Budget proposed $634 billion over ten years in a budget-neutral health reform reserve fund, to be financed by savings in two areas.

First, the Budget proposes to reduce the itemized deduction rate for families with incomes over $250,000, which is expected to save $318 billion over ten years. Second, the Budget estimates $316 billion in savings over ten years in the Medicare and Medicaid

programs. These savings result from promoting efficiency and accountability, aligning incentives toward quality, and encouraging shared responsibility, and described more fully in the FY 2010 Budget (pp. 28-29, 127).

15. Medicare Advantage and patient choice

The budget document states that the President will adhere to the principle of guaranteeing choice. Specifically, the document states: "The plan should provide Americans a choice of health plans and physicians." On the campaign, he also said if you like the health care plan you have, you can keep it. This budget, however, cuts payments for Medicare Advantage plans by $175 billion, which means that several million beneficiaries will lose access to these plans. This is a direct contradiction; the President wants to preserve choice on one page and eliminate choice on another page. Will you please explain this discrepancy?

Response

The Administration believes in the importance of choice for Medicare beneficiaries. However, these choices should not be financed by significant overpayments by the Federal government. Accordingly, the Administration believes that Medicare beneficiaries should continue to have the choice of enrolling in private Medicare Advantage (MA) plans, provided that the plans operate efficiently, provide quality care, and are paid appropriately by Medicare. The MA competitive bidding system proposed in the FY 2010 President's Budget would help to achieve these objectives by better tying plan payments to actual costs, while still giving beneficiaries access to plan choices. Medicare currently pays MA plans about 114 percent, on average, of the amount a beneficiary would cost in Medicare's traditional fee-for-service (FFS) plan, according to MedPAC. These overpayments increase the Part B premiums paid by beneficiaries participating in traditional FFS, worsen the fiscal sustainability of Medicare, and increase the burden on taxpayers.

16. HIV/AIDS funding

The President's budget increases funding for HIV/AIDS treatment, prevention and care, but does not place a specific number on that increase for domestic HIV/AIDS. Can you elaborate on this statement? How much funding will the President dedicate to fighting HIV/AIDS domestically? What programs will see an increase in funding? What will be his top priorities for HIV/AIDS? Finally, how will the administration ensure that Ryan White grantees receive equitable funding based on HIV caseloads?

Response

The Administration supports increasing resources to detect, prevent, and treat HIV/AIDS domestically, especially in underserved populations. Information on funding for HHS's HIV/AIDS treatment, care, and prevention activities will be provided as part of the detailed Budget to be released in early May.

17. CDC funding

The President's budget outlines increases for many agencies under the Department of Health and Human Services, but does not mention one of the most important, the Centers for Disease Control and Prevention. Public health initiatives are vital to accomplishing the goals the President will increase funding for the CDC? How will the President ensure that our public health agency is equipped to prevent and react to public health threats?

Response

Information on funding for CDC will be provided as part of the detailed Budget to be released in early May.

18. Recovery Act investment

The Recovery Act of 2009 in President Obama's words is supposed to be "timely, targeted, and temporary," increasing job growth and producing economic recovery. Some of the areas targeted by the 2-year spending are education, science, health care, biomedical research and renewable energy. However, the ability of these activities to lead to economic growth takes 5 to 10 years at least. Do you believe these critical areas can contribute to economic expansion with a temporary investment? Or does the President propose instead to incorporate this funding in the baseline and permanently expand the Federal budget?

Response

The Recovery Act's investments in education, science, renewable energy, health care, and biomedical research and renewable energy will create jobs now, by contributing directly to aggregate demand. For example, the extra spending on education will keep teachers employed and immediately help protect education quality from the effects of the economic downturn.

The Recovery Act is timely, targeted, and temporary. That does not mean that all those areas in which the Recovery Act invests should be ignored once the recession ends. Increased spending on education, science, biomedical research, renewable energy and health is necessary for short-term growth but also lays the foundation for long-term economic health—and these are areas that have been too long neglected. Therefore, the President's FY 2010 Budget includes key investments in these areas that will build upon what has already been accomplished in the Recovery Act and help provide for long-term prosperity.

19. FDA funding

We know that FDS is overworked and underfunded. I was pleased to see a proposed increase for food safety efforts. However, it is not clear if this is a billion dollar increase,

or a billion dollars total. It is also not clear if this is just for FDA's Center for Food Safety and Applied Nutrition, or if it would also be for the Center for Veterinary Medicine. Could you please clarify and give more detail about this proposed increase?

Response

The President's Budget proposes to invest over $1 billion in FDA's food safety activities in FY 2010. This is a more than 20 percent increase from the 2009 enacted level. More information on FDA funding will be provided as part of the detailed Budget to be released in early May.

OMB Director Peter R. Orszag, Responses to Questions for the Record from Senator Feingold (Senate Budget Committee hearing, March 10, 2009)

1. DOD funding request

Secretary Gates has written to Congress that he would need $65.9 billion more in emergency spending for overseas operations in 2009, including $5.8 billion in ongoing foreign military assistance and military intelligence. Meanwhile, President Obama has requested $75.5 billion in emergency-spending for overseas operations in 2009. If you do not include foreign military assistance or military intelligence in the emergency spending request, then there is a $15 billion difference between request made by Secretary Gates and the President's final request. What accounts for the difference?

Response

Last December Secretary Gates estimated that DoD would need $69.7 billion to fund overseas operations, including military intelligence, for the remainder of FY 2009 ($65.9 billion, the figure in the question, was the amount enacted in the FY 2009 bridge). In February, the Administration requested $75.5 billion for these activities.
As compared to the Secretary's initial estimate, the Administration's request adds funding to support additional troops that are being deployed in Afghanistan, while, at the same time, it reduces other elements of Secretary Gates' estimate. These changes net to the $5.8 billion difference between Secretary Gates' estimate and the Administration's request.

2. Cost of Afghanistan troops

How much do you anticipate that the increase in troop levels in Afghanistan will cost? What makes up for the remainder of the increase in the request?

Response

The President's FY 2009 supplemental request for DoD of $75.5 billion reflects the additional funding for more troops in Afghanistan, along with reductions to other elements of the Secretary's December estimate. In fact, funding in 2009 for operations in Iraq and Afghanistan under the Administration's policies would be about $50 billion below the 2008 level, adjusted for inflation, reflecting a phase-down in operations in Iraq.

3. USDA dairy purchases

During the last few months farmers in general, but particularly dairy farmers, have seen the prices they receive plummet as global demand for dairy products has fallen off leaving a surplus of dairy products on the market. At the same time there has been a significant increase in demand for programs that provide food assistance. I recently led a letter with Senator Kohl and 33 of our colleagues that among others things requested that the USDA purchase additional dairy products for use in the nutrition programs. Doing so

should help farmers by clearing the surplus of dairy products from the market allowing prices to recover more quickly, while at the same time providing a supply of nutritious dairy products for those who need some assistance. From a budget perspective, the spending would be partially offset by savings from the dairy safety net or Milk Income Loss Contract program since a faster price recovery would mean smaller and fewer months of MILC payments.

Does the President support the use of available USDA funds such as those from Section 32 during this fiscal year to purchase dairy products? Has the budget provided additional resources for commodity purchases such as these for dairy products?

Response

On March 26, 2009, Secretary of Agriculture Tom Vilsack announced that approximately 200 million pounds of nonfat dry milk (NDM) will be transferred from the Commodity Credit Corporation (CCC) to USDA's Food and Nutrition Service for use in domestic feeding programs. The goal is to help care for U.S. citizens who are struggling to put nutritious food on their tables.

The Food and Nutrition Service (FNS) has identified several domestic feeding programs that will benefit from this transfer of 200 million pounds of NDM. USDA's Farm Service Agency will assist FNS in acquiring the desired dairy products. Products should be moving through the supply chain starting this spring and continuing through 2009. USDA also plans to make available NDM for use in international feeding programs, including the U.S. Agency for International Development and the Foreign Agricultural Service McGovern-Dole International Food for Education and Child Nutrition program. The Administration looks forward to working with you and other members of Congress on developing policy that protects family farmers and also improves Americans' nutrition.

OMB Director Peter R. Orszag, Responses to Questions for the Record from Senator Gregg (Senate Budget Committee hearing, March 10, 2009)

1. NDD Spending

Director Orszag, you testify that "the budget reduces non-defense discretionary spending – that is, the spending appropriated each year outside of defense – to its lowest level as a share of GDP since data began to be collected in 1962."

You claim under the President's budget, in 2019, non-defense discretionary outlays will be 3.1 percent of GDP.

But your budget for the next 10 years also proposes to:

- move Pell Grants to the mandatory side of the budget (when they had been counted on the discretionary side from 1962-2008)
- count aviation revenues as offsets to spending instead of on the revenue side of the budget where they appeared during the 1962-2008 series, and
- omit disaster spending from the discretionary totals even though the historical series shows such spending as discretionary.

Questions:

a) Isn't it true that once you adjust the budget's non-defense discretionary spending totals to be consistent with the way such totals were added up for 1962-2008, the ratio of such spending to GDP in 2019 would be 3.5%, not 3.1%?

b) Isn't 3.5% a ratio of nondefense discretionary spending to GDP that is the same as or higher than the comparable ratio for 11 of the years in the 1962-2008 period? So it wouldn't be the lowest ever, would it?

c) Why don't you make the correct adjustment for comparability? Is that transparent budgeting? Is that honest budgeting to make this claim?

d) Why – in a budget request for 2010 (which increases non-defense discretionary spending by 11.5 percent over 2009) – should we even care about or take seriously a claim about 2019 when this President won't even be President anymore?

e) Traditionally, Presidents (and their OMB) argue that Congress should only take seriously the discretionary request for the budget year and that the subsequent years are not that meaningful since those years will be addressed in subsequent budget submissions. Would you be willing to lock in with statutory caps on discretionary spending in discretionary levels to be enacted for 2009 adjusted for inflation to guarantee that the percentages you promise will be achieved?

Response

a) I agree that the historical comparisons should be on a consistent basis. For consistency, Pell should be removed from the historical series for discretionary outlays. By contrast, no adjustment is necessary for the Administration's proposal to restructure FAA financing, because this is a shift from a tax-based system to a user-fee based system, and market-based user fees are properly netted against spending. Likewise, no adjustment is necessary for the Administration's allowance for disaster costs, because this allowance could ultimately be realized as mandatory spending, discretionary spending, or tax relief for affected areas - or not even realized at all. For the Pell adjustment, the Department of Education has compiled a historical series of Pell discretionary outlays by fiscal year. These outlays are a portion of the overall outlays in the Department's Student Financial Assistance Account.

b) Making the historical adjustment described above, NDD outlays of 3.1 percent of GDP are the lowest on record, lower than the previous low of 3.2 percent in 1999. (The figure for 1999 is adjusted to remove $7.4 billion in Pell costs based on the data from the Department of Education cited above.)

c) The figures above make the adjustment for comparability.

d) The President's Budget includes a 10-year budget horizon because we need to focus on our longer-term fiscal outlook. While this outlook will be affected by the decisions of future Presidents and Congresses, it is essential for us to engage in long-term planning--planning that will allow us to make key investments and improve the fiscal picture. The President's Budget does so by not engaging in short term thinking and laying out a realistic 10-year budget plan.

   Past budgets have engaged in various fiscal gimmicks to improve the deficit outlook by not showing costs in the outyears that policymakers fully expected to pay for. One of the well-worn gimmicks is to hold discretionary spending below the levels that the Administrations expected to propose when the outyears became the budget year. This is why these past Administrations would sometimes quietly suggest that outyear discretionary numbers should not be taken seriously, even as those administrations would stand by the deficit figures that were, in part, based on these unrealistic proposed levels of discretionary spending.

   This Administration has taken a different route and proposed a budget that is unprecedented in its honesty and transparency. The discretionary spending totals in the Budget reflect the Administration's preferred policy path. In fact, the Budget even includes increased funding for the Census as of 2019 in order to pay for the ramp up to the 2020 Census.

e) It would be inappropriate to set discretionary caps at the 2009 level, adjusted for inflation. First, 2009 enacted appropriations are boosted by nearly $270 billion in

one-time funding for the Recovery Act. Second, discretionary totals for 2009 would include funding of $141 billion for operations in Iraq and Afghanistan, if the supplemental proposed by the Administration is enacted. Inflating 2009 appropriations including both the Recovery Act and full funding for the wars in Iraq and Afghanistan would not produce a useful target for future discretionary spending.

But if the Recovery Act and funding for Iraq and Afghanistan were excluded from the 2009 discretionary funding levels and caps were set based on the remaining funding adjusted for inflation, this would undercut the nation's defense and underfund key priorities. This level of funding would not provide for overseas military operations going forward; nor would it allow for any increase in benefits for the nation's veterans. Furthermore, key priorities—clean energy, infrastructure, and education—would have to go unaddressed.

The President's Budget responsibly provides for the nation's defense; expands health benefits for our nation's veterans; and makes key investments in clean energy, infrastructure, and education. The Budget does so while still cutting the deficit in half by 2013 and controlling non-defense discretionary spending so that it falls to its lowest level on record as a share of the economy by 2019.

2. Cap and Trade, legislative proposals

As Director of the Congressional Budget Office, you testified before the Senate Finance Committee on the "Implications of a Cap-and-Trade Program for Carbon Dioxide Emissions" on April 24, 2009 that "On the basis of a review of the existing literature and the range of CO2 policies now being debated, CBO estimated that by 2020, the value of those allowances could total between $540 billion and $300 billion annually (in 2006 dollars)."

Can you specify which cap and trade legislative proposals were reviewed to develop CBO's $50 billion to $300 billion per year estimate for the value of allowances? Do any of the legislative proposals used in those estimates model or closely model S. 390, the Boxer-Sanders bill from the 110th Congress or the President's proposal in the budget?

Response

CBO estimated the potential value of allowances under a cap and trade program through a review of literature reports and the range of legislative proposals at that time. In any specific proposal, the value of allowances depends on a number of factors, including the stringency of the cap, the assumed cost of compliance technology, the availability of greenhouse gas offset provisions, the banking and borrowing of carbon credits, and the existence of price floors and ceilings, among other cost-containment mechanisms. All of these issues must be carefully considered when drafting legislation, and as the Administration works with Congress to develop a specific cap and trade proposal, the

Administration will work to estimate projected allowance prices, revenues raised by the proposal, and compensation that would be funded by these proceeds.

3. Cap and trade, revenues vs. S. 3036

In your November 2007 testimony to the U.S. House of Representatives Committee on Budget on "Approaches to Reducing Carbon Dioxide Emissions," you asserted: "...Under the range of cap-and-trade policies now being considered by the Congress, the annual value of emissions allowances would be roughly $50 billion to $300 billion by 2020 (measured in 2006 dollars). More-stringent caps would result in higher total allowance values." (emphasis added). According to your November testimony, "more stringent caps would result in higher total allowance values."

Given that the President's cap and trade proposal requires 100 percent auction and an 83 percent reduction of GHG emissions, and is therefore more stringent that the Boxer-Lieberman-Warner Substitute, S. 3036 (110th Congress), which included approximately a 50 percent auction of allowances and a 66 percent reduction in GHG emissions, does the Administration estimate that annual and total revenues would be far greater under the President's proposal than S. 3036?

Response

Tables S-2 and S-6 of the Budget show the estimated year-by-year climate revenues dedicated to the Making Work Pay Tax Credit—about $526 billion through 2019—and investment in clean energy technologies—about $120 billion over the next decade. Any additional revenues would be used to compensate the public, including vulnerable families and communities. As the Administration works with Congress to develop a comprehensive climate policy, projections of the revenue will be made. To the extent that such legislation applies tighter caps, the program would tend to generate greater revenue than it otherwise would—revenue that, under the framework outlined by the Administration, would be used for clean energy investment and to compensate the public through Making Work Pay and other priorities. Note that the level of projected revenue depends on more than the structure of the cap and trade program. For instance, estimates are sensitive to projected emissions levels—and current projections of "baseline" emissions are generally lower than those made last year, which would tend to result in lower projected revenue.

4. Cap and trade, job impacts

The President's proposal will have costs, and these costs will be even more significant during times of high energy prices or recession. What are the estimated impacts to jobs economy-wide and in the manufacturing sector?

Response

The Budget assumes that the first allowance auctions would take place in 2012, after the economy recovers from the current recession. A strategy to promote energy security and tackle global warming will create new jobs and bolster the long-term viability of the economy, promote a stable, diverse and resilient energy supply while also taking crucial steps to avoid the most devastating effects of climate change. Cap and trade will encourage such job creation in clean energy sectors, and the Budget would further invest $15 billion per year in clean energy technologies starting in 2012.

Note that cap and trade programs tend to be "countercyclical"—since allowance prices tend to fall during periods of slow economic growth. In this way, a cap and trade program could have the ancillary benefit of acting as an "automatic stabilizer" for the economy in future business cycles.

5. Cap and trade, tax increases

The President's campaign promise to Americans was not to raise taxes on individuals with adjusted gross income under $200,000 per year and families making under $250,000 per year. The President's budget proposes a carbon revenue stream of approximately $80 billion annually between FY 2010 and FY 2019, of which $63 billion to $68 billion per year is directed toward the Making Work Pay Tax Credit for a total of $525.7 billion over the 10 year budget window.

The Making Work Pay Tax Credit phases out for taxpayers with adjusted gross income in excess of $75,000, or $150,000 for married couples filing jointly. However, the President's cap and trade proposal levies taxes on all Americans, including those individuals with adjusted gross income between $75,000 ($150,000 for couples) and $200,000 ($250,000 for couples). In doing so, the cap and trade proposal taxes segment a segment of taxpayers that the Administration promised would not be taxed.

The President's cap and trade tax increases is inconsistent with his promise to not raise taxes a dime on those making under $250,000 if you're married, and $200,000 if you're single, isn't that correct?

Response

Consistent with the President's campaign pledge, his FY 2010 Budget does not raise taxes on families making less than $250,000 or singles making more than $200,000, and it gives tax cuts to 95 percent of working Americans. This looks at what is collected through the tax code and what is returned through the tax code.

The cap and trade program is not part of the tax code. And if its effects on households are being counted, then it makes sense to look at the effects of the Budget as a whole on working families. From this comprehensive perspective, the bottom line remains the same—the Budget would improve the financial reality of the vast majority of American

families, by expanding college opportunity by increasing the size of Pell grants and making the program mandatory, by reducing health care costs, and by investing in energy and infrastructure.

6. Education -- FFEL market risk

Given the President's expressed commitment to honest and transparent budgeting, is it disingenuous for the Administration's major student loan proposal (i.e. the policy to phase out the Federal Family Education Loan program and origination of all student loans throughout the Direct Loan program) to be scored using a procedure that omits loan administration costs and the concept of market risk? If we factored in these omissions to the estimate of the budgetary effect, wouldn't OMB's estimated savings be much smaller?

Should we ensure that the true budgetary effects are measured for proposals, such as this student loan proposal, by changing the Federal Credit Reform Act of 1990 to apply the market risk concept to all Federal credit programs, as you have supported in the past when evaluating the budgetary impact of the TARP program and Treasury's purchases of Mortgage-Backed Securities?

Response

The additional costs of life-of-loan servicing entailed by the Administration's proposal to move to 100 percent direct loans will be presented in the Appendix of the forthcoming full Budget submission. The credit subsidy cost estimates of the proposal are based on the existing requirements of the Federal Credit Reform Act of 1990 (FCRA) and therefore do not incorporate market risk-adjusted discount rates, which would affect the subsidy estimates for both the Federal Family Education Loan (FFEL) and Ford Direct Loan programs. The FFEL program, like the Direct Loan program, also involves market risks. Therefore it is unclear how a complete consideration of market risk would affect the savings estimated for our student loan proposal. On balance, even with the additional administrative costs, and if market risk-adjusted discount rates were used to estimate the subsidy costs, originating 100 percent of Federal student loans through the Direct Loan program would very likely result in significant taxpayer savings by eliminating FFEL subsidies.

As you know, in enacting the FCRA, Congress required agencies to use risk-free Treasury rates for discounting risk-adjusted credit program cash flows. By contrast, Section 123 of the Emergency Economic Stabilization Act directs that credit subsidy cost estimates for the Troubled Asset Relief Program be calculated by adjusting the discount rate under the FCRA for market risks. The idea of amending the FCRA to capture market risk for all Federal credit programs is complicated, involving a number of trade-offs, and I look forward to working with you and other members of Congress to evaluate the methods, benefits and challenges of such a change.

7. Education -- Direct student loan capacity

During this hearing, you stated that the Administration has done "significant work to make sure that the [Direct Loan] program would ramp up and adequately so that there would be no disruptions" in student loan origination and servicing.

Please describe this "significant work" in detail to the Committee. What leads you to believe that the Department of Education is capable of taking on the entire $80 billion student loan volume without any disruptions to the process, keeping in mind that the Direct Loan program only accounts for approximately 20% of the overall volume today?

Response

The Department of Education (ED) has been ramping up its servicing capabilities, both in response to the budget policy and to support the FFEL loan purchase programs established last summer. For example, the Department recently issued a request for proposal for additional servicers to handle volume associated with the emergency programs implemented this past academic year. ED is now in the process of evaluating proposals from numerous servicers. The Budget proposal will maintain competition because ED will begin using multiple contractors to service additional Direct Loan (DL) volume. This will maintain competition between servicers, and students and families will benefit from improved customer service and technological advances in loan servicing. Though there will certainly be operational challenges associated with originating all Federal student loans, the Department is already taking the right steps for a smooth transition.

8. LIHEAP trigger

In FY 2009, Congress appropriated $5.1 billion for LIHEAP, which exceeded the President's budget request by $3.1 billion and nearly doubled the $2.57 billion provided for the program in FY 2008.

The Administration's FY 2010 budget proposal provides $3.2 billion for the Low-Income Home Energy Assistance Program (LIHEAP) and creates an automatic trigger mechanism to provide increases in energy assistance when energy prices spike. The FY 2010 budget proposal provides for $329 million in FY 2010, increasing to $450 million in the out years for the trigger mechanism.

Does the Administration intend to use the trigger mechanism to supplement or to replace the current contingency funding process?

The current LIHEAP contingency funding process allows members of Congress to petition the President on behalf of their state officials and constitutes to release contingency funds during price spikes and significant cold weather periods.

Does the Administration believe that a trigger formula would better determine when low-income individuals and seniors need energy assistance rather than local, state, and Federal representatives who have direct contact with those in need of assistance?

What price/formula will trigger the mechanism? At what price would home heating oil be considered too expensive and what temperature would be considered too cool?

Response

The President's FY 2010 Budget includes $3.2 billion for LIHEAP for both block grant and contingency funding. The Administration does not propose to use the LIHEAP trigger mechanism as a substitute for the current contingency funding process. Instead, the trigger is designed to quickly and automatically provide additional funding when assistance is needed due to spikes in energy prices.

The level of funds made available for obligation by the trigger would be directly related to the magnitude of energy price changes. Funds would be allocated among States at the discretion of the Administration, taking into account the impact of the price increases that triggered the release and the percent of low-income households in the States that use that fuel type. In addition, the Administration could allocate some portion of the triggered funds to States adversely impacted by extreme heat or cold, energy supply disruptions, or a variety of other energy-related emergencies. States and localities would retain the flexibility to use triggered LIHEAP funds in a manner that best meets the particular energy needs of their low income populations.

Our preliminary approach in designing the LIHEAP trigger would provide additional funds when quarterly energy prices are higher than quarterly prices in the previous year. For heating oil and natural gas, additional funds would trigger in tiers when Quarter 3 and 4 prices are at least 15 percent (tier 1) or 30 percent (tier 2) higher than quarterly prices in the prior year. For electricity, additional funds would be provided when quarterly prices are at least 10 percent higher. While we do not currently propose a weather-based trigger, the Administration would have the discretion to allocate contingency funds and some triggered funds to States adversely impacted by severe weather. In addition, we are open to the concept of using weather conditions as well as prices in the design of a trigger mechanism if this can be done in a workable manner and does not increase the total estimated cost of the mechanism.

9. Transportation obligation limitations

The FY10 budget proposes to treat obligation limitations for transportation programs as discretionary budget authority. This is a significant break from the current byzantine practice of treating transportation contract authority as mandatory budget authority and the outlays as discretionary.

How does the Administration defend its proposal against critics who say this proposal violates the "user pays" concept? Or have transfers from the General Fund into the Highway Trust Fund, for example, already violated the concept?

Why not eliminate contract authority entirely?

Both the highway program and aviation program are undergoing reauthorization this year. How would this proposal affect these bills?

Response

In the interest of transparency, the President's FY 2010 Budget included a scoring change to count contract authority (CA) as discretionary budget authority (BA) in an amount equal to the appropriated obligation limitation. This proposal relates to scoring rules, not to the question of how the government should pay for transportation programs. There are many potential ways to simplify and make more transparent how the Federal government budgets for transportation programs, and the Administration is open to exploring other options with Congress.

The Administration strongly supports the goal of putting transportation programs on a sustainable financing path. The funding levels included in the FY 2010 Budget are place-holder baseline spending and revenue estimates. They do not represent the Administration's surface reauthorization or long-term funding goals. We look forward to working with the Congress to develop proposals that will strengthen America's infrastructure and achieve long-term sustainability for the highway trust fund.

OMB Director Peter R. Orszag, Responses to Questions for the Record from Senator Murray (Senate Budget Committee hearing, March 10, 2009)

1. Home visiting programs

I was very excited to see the focus on Home Visiting Programs in this budget. As you well know, home visiting programs have been shown to increase school readiness, lessen the likelihood of child abuse and neglect, and assist in the early identification of developmental and health delays.

In Washington state, as around the country, we have many types of home visiting programs that have been shown to be effective; whether nurse home visiting or home visiting programs involving social workers and child development specialists.

As you know, Senators Bond, Clinton and I reintroduced the Education Begins at Home Act this year, which has broad support from the early education community, and includes all types of effective home visiting programs. It is my hope that going forward this year, we can work together to ensure that this Administration's Nurse Home Visiting Program proposal can be expanded to include all Home Visiting programs that are effective, including other types of providers.

- Would you be willing to work with me and my colleagues to ensure that all effective home visiting programs are included in any federally-supported Home Visiting initiative?

Response

Randomized control trials in multiple locations have shown very strong benefits to children and their parents from Nurse Home Visitation in particular. We appreciate the variety of ideas on home visitation that enjoy strong support from congressional members on both sides of the aisle, and we look forward to working with the Congress to enact a program that helps our most vulnerable families give their children a head start in life.

2. OSHA programs

State Occupational Safety and Health programs now serve close to half of the states in our country, including Washington State. These programs extend to reach of OSHA's ability to keep workers safe and healthy on the job. But for too long, they have been underfunded due to inadequate requests by the former Administration.

- What will we see in this Administration's budget request that will give struggling state OSHA programs the necessary weight and resources to support OSHA's mandate to protect America's workers?

Response

The Administration is committed to ensuring that every American worker has safe and healthful working conditions. The President's 2010 Budget honors this commitment by providing increased funding for the Occupational Safety and Health Administration. Detailed information on State OSHA program funding will be provided as part of the detailed Budget released in early May.

3. Evidence-based decision making (parts a-c)

Our current fiscal situation and the principals of good government demand that we prioritize our investments. I understand that as part of the new era of responsibility, OMB will no longer use the former Administrations PART performance assessment tool, but it will look for evidence-based results to determine program effectiveness. While I agree with this emphasis, I'm concerned that the last eight years of mismanaged priorities have led to less than solid data performance analysis.

- How will OMB ensure that agencies have the resources and tools they need to properly measure program effectiveness?
- What plans does OMB have to employ a new program performance tool, or specific guidance for program performance to replace PART?
- Given the questions surrounding the accuracy of data collected over the last few years, how will you ensure that valuable programs are not cut or overlooked in the FY 2010 budget?

Response

The President is committed to improving government performance, making government programs more efficient, and delivering more return to Americans for their hard-earned tax dollars. The Administration's management reform agenda will focus on goals Americans care about and that are based on Congressional intent and feedback from the people served by government programs. Program success will not be measured in isolation, but assessed in the context of other programs serving the same populations or meeting the same goals. We plan to engage with agencies and Congress in the coming months to identify a limited set of high priority goals that will help serve as the basis for this agenda.

4. Evidence-based decision making (part d)

Data validity goes beyond determining program effectiveness. To be useful to policy makers and practitioners, it must be timely, accurate, and scientifically sound. While the last Administration put a great deal of emphasis on "results driven decision making" data collection was often lacking; measures were not always timely; and methodologies painted a skewed picture of what was often called "success." For example, the previous

Administration told us workers were safer than ever although safety standards and enforcement were scarce. The same Administration expressed concern about recent GAO whistleblower study that did not take into account resource constrains in making its recommendations about the need for more timely and accurate investigation and documentation of complaints of employer retribution.

- How will OMB ensure that the Department of Labor has adequate resources to collect accurate, timely, and scientifically sound data that provide a true picture of safety on the job, enforcement of workers' rights, and the impact of economic conditions on America's workers?

Response

The Administration shares your interest in ensuring the timely and accurate collection of workplace and economic data. The President's 2010 Budget provides strong support for the Department of Labor's worker protection agencies, as well as for the Bureau of Labor Statistics. Detailed information on funding for these programs will be provided as part of the detailed Budget released in early May.

5. Agriculture research service

As you know, agriculture research is so important to keeping our farmers competitive in a global marketplace. But too many of our ag researchers are working in cramped, outdated and dangerous buildings. I've been working for eight years to help build a new ag research building on the Pullman campus of Washington State University in my state. As I'm sure you are aware, there is a major backlog in building these new facilities because the funding has been trickling in the form of $1-2 million appropriations over the years.

- Will you commit to working with me to really focus on making these new facilities a priority within the USDA budget?

Response

The Administration believes that agricultural research has an important role to play in responding to the problems and challenges facing the nation in the 21st century. Up-to-date research facilities can help meet these challenges. I look forward to working with you and other members of Congress to develop a cost-effective strategy to strengthen USDA's research infrastructure.

OMB Director Peter R. Orszag, Responses to Questions for the Record from Senator Nelson (Senate Budget Committee hearing, March 10, 2009)

1. NASA funding

Dr. Orszag, your 2010 budget request for NASA is $18.7B. When combined with the $1B directed to NASA in the stimulus bill this results in $1.7B more than the amount planned by the Bush administration. However, your current out-year projections for NASA flat-line the agency through 2012, without even an increase for inflation.

Your projections for 2011, 2012, and 2013 add up to $1.2B less than what the Bush administration projected NASA would need in this timeframe.

Do you really intend to flat-line NASA's budget in these years?

Response

The Administration supports a robust and balanced civilian space program. The President's request, which includes a large increase for NASA in 2010, will enable the agency to not only inspire the world with both human and robotic space exploration, but also to lead in confronting the challenges we face here on Earth. The budget sustains this higher funding level in the out years—providing a total of $1 billion more than the Bush budget from 2009 to 2013.

At this budget level, NASA will be able to help America maintain its innovation edge, contribute to American economic growth, and continue its tradition of discovery.

THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL FOR THE DEPARTMENT OF ENERGY

WEDNESDAY, MARCH 11, 2009

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

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

Present: Senators Conrad, Murray, Wyden, Nelson, Stabenow, Cardin, Sanders, Whitehouse, Warner, Merkley, Gregg, Enzi, Sessions, Bunning, Crapo, Graham, and Alexander.

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

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The hearing will come to order.

I want to welcome Secretary Chu here to the Senate Budget Committee. Welcome. Good to have you here.

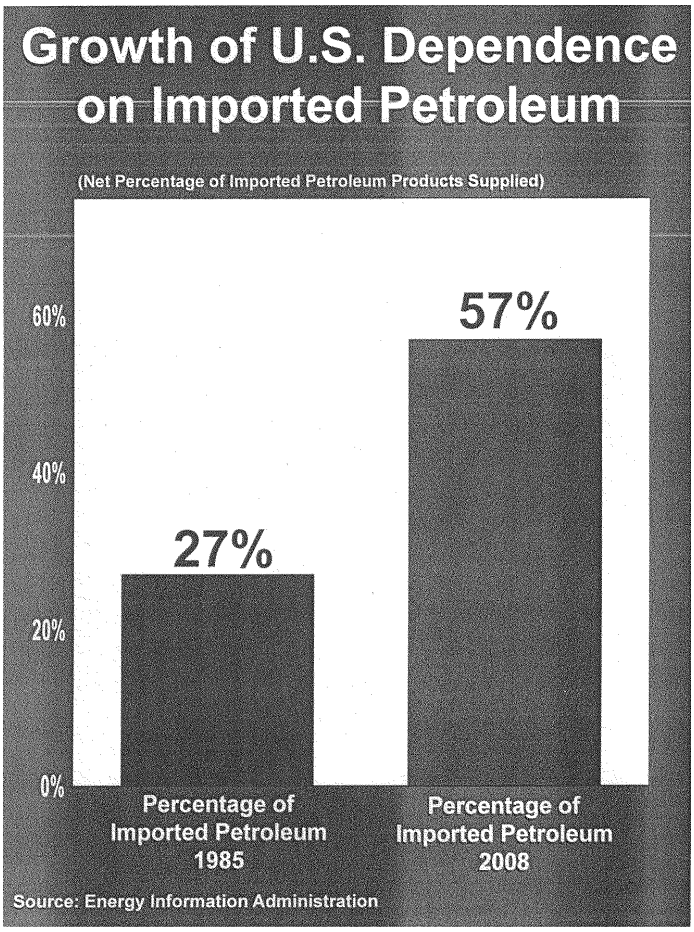
Secretary Chu is one of the Nation's leading scientists. In 1997, he was a co-winner of the Nobel Prize for Physics. Prior to his nomination by President Obama, he was Director of the Department of Energy's Lawrence Berkeley National Lab. He was Director of the Department of Energy's Lawrence Berkeley National Lab and a professor of physics and molecular and cell biology at the University of California. As a proud graduate of Stanford, we still respect the University of California, I want to assure you of that.

[Laughter.]

Chairman CONRAD. At Lawrence Berkeley, he steered the lab's effort in pursuit of new alternative and renewable energies, and so he is ideally suited to lead the Department of Energy at this time. We are pleased that Secretary Chu could join us, and we look forward to his testimony.

I do not believe it has ever been more clear that our Nation's economic and national security are directly linked to our energy policy. We simply must address our Nation's addiction to foreign oil and confront the challenge of global climate change. And in the process, we can create new green jobs and an alternative energy and energy efficiency that will help our Nation's economy recover.

The fact is we are still dangerously dependent on foreign oil. In 1985, we imported only 27 percent of our petroleum. We now import almost 60 percent of the petroleum that we use. As a result, we are becoming increasingly vulnerable to oil supply disruptions and instability in other parts of the world.



This addiction to foreign oil is a direct threat to our national security. Many of the countries from which we import petroleum are in unstable or unfriendly regions. Here is a list of the top 15 countries exporting petroleum to the United States in 2008 and the number of barrels of oil we import in a single day. You can see that we import large quantities of oil from countries like Saudi Arabia, Venezuela, Nigeria, Angola, Iraq, Algeria, and Colombia.

Top 15 Countries Exporting Petroleum to the United States in 2008

	Barrels Per Day
Canada	2,459,000
Saudi Arabia	1,532,000
Mexico	1,299,000
Venezuela	1,191,000
Nigeria	990,000
Angola	513,000
Iraq	627,000
Algeria	547,000
Russia	463,000
British Virgin Islands	320,000
Ecuador	221,000
Brazil	258,000
Kuwait	210,000
Netherlands	167,000
Colombia	200,000

Source: Energy Information Administration (Current As of 2/27/09)

We must also address climate change. The scientific consensus is clear. Here are the conclusions of the Intergovermental Panel on Climate Change, and I quote: "Warming of the climate system is unequivocal, as is now evident from observations of increases in global average air and ocean temperatures, widespread melting of snow and ice, and rising global average sea level. Continued greenhouse gas emissions at or above current rates would cause further warming and induce many changes in the global climate system during the 21st century. We have an obligation to current and fu-

ture generations to take meaningful action to reduce greenhouse gas emissions."

The economic recovery package included some key energy investments to begin to address these issues. It included $11 billion for a downpayment on modernizing the electrical grid; $6.3 billion for local government energy efficiency and conservation grants; $6 billion for renewable energy and transmission loan guarantees; $5 billion for weatherization assistance; $3.4 billion for carbon capture and sequestration technology; $2.5 billion for energy efficiency and renewable energy research and development; and $2 billion for advanced battery development.

President Obama's budget takes further steps. The budget includes $26.3 billion in discretionary funding for the Department of Energy for 2010. The President's cap-and-trade proposal would reserve $15 billion of revenue beginning in 2012 for clean energy technology. And the budget builds on investments in the economic recovery package by increasing support for solar, biomass, wind, and geothermal energy; advancing development of low carbon coal sequestration; investing in transmission infrastructure to improve energy efficiency and reliability; and providing significant increases for basic research and science. We look forward to hearing more details from Secretary Chu.

Despite these advances in energy policy and new commitments of funding to energy, it is clear that this is going to require a sustained effort for years to come. Here was a headline in the Washington Post just last month: "Alternative energy still facing head winds despite Obama's support. Projects tripped up by financing and logistics." So we know addressing our addiction to foreign oil and global climate change will not come easily, but it must be done.

The Washington Post

TUESDAY, FEBRUARY 17, 2009

Alternative Energy Still Facing Headwinds

Despite Obama's Support, Projects Tripped Up by Financing, Logistics

By PETER SLEVIN
and STEVEN MUFSON
Washington Post Staff Writers

BOULEVARD, Calif. — The late afternoon light is shining golden on the high chaparral as Donna Tisdale stands near a faded 1800s ranch house, scans the unblemished surrounding hills and sees trouble on the horizon.

"The ridge right there will have turbines on it," she says, squinting west into the setting sun. Turning north and east, where a pristine ridgeline meets the sky, she points out the route of a $1.9 billion electricity transmission line whose 150-foot towers will march 123 miles from the Imperial Valley to energy-thirsty San Diego.

"No matter which way you look, you won't be able to get away from it," laments Tisdale, a rancher and political activist in McCain Valley who is trying to block the power line. "I hate when outsiders come in and take what they can and then leave."

The three-year fight over the Sunrise Powerlink, which is designed to carry solar, wind and geothermal energy, typifies the serious challenges facing President Obama and many of the nation's governors as they tout the power of renewable energy to put people to work and rescue the planet from the effects of climate change.

The nation's richest resources of renewable fuel — primarily wind and solar — lie in distant deserts, vast plains, and remote valleys and hilltops like this one, far from the populous cities where energy is most needed. Thousands of miles of new power lines will be required to bring renewable energy to cities and suburbs, a vast undertaking that will cost untold billions of dollars in public and private money and will require compromise by dueling interest groups and people such as Tisdale.

Obama, who made the country's en-

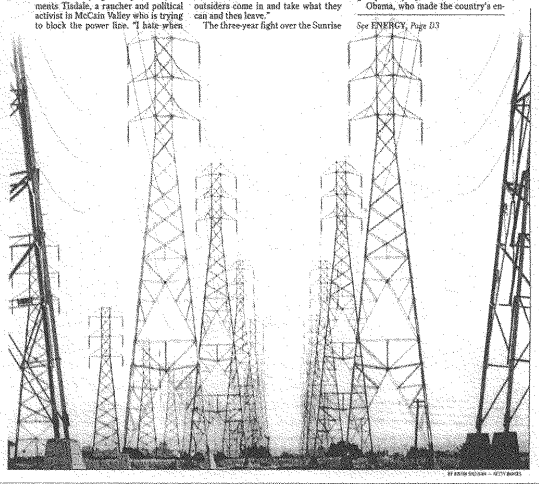
See ENERGY, Page D3

Hubs of Power

Top five producers of non-hydroelectric renewable energy, where additional power lines may be needed, in October 2008 (last month for which data were available).

State	Megawatt hours
California	1.99 million
Texas	1.39 million
Minnesota	409,000
Florida	319,000
Washington	304,000

SOURCE: Energy Information Administration



BY BRYAN SCHUMAN — ACTIV IMAGES

With that, I want to turn to my colleague Senator Gregg for his opening remarks, and then we will go to Secretary Chu for his opening statement, and then we will go to 7-minute questioning rounds. Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman, and it is a great honor to welcome Secretary Chu here, and to have him serving in

the Government. We really appreciate that someone of your stature and ability has chosen to come into the Government.

I am concerned, as the Chairman is, about our reliance on foreign oil. I think we as a Nation, if we are to address not only our national security needs but our economic concerns, have to do something about this. That is why I was a strong supporter of the initiatives on which we had some traction last year but, unfortunately, have been recently sidetracked by this administration, which is, to summarize, drill more domestic product and conserve more.

I am also concerned about climate change, and I think we should try to move away from carbon-based production of energy. And that is why I have been a strong supporter of nuclear power. And I am genuinely concerned about this administration's approach to nuclear power.

If you look at the recent stimulus bill that was passed, stripped from that bill was $50 billion of loan guarantees which would have helped us fund an expansion of nuclear power. If you look at the proposals of this administration relative to Yucca Mountain and the disposal of waste, it is basically a proposal which, as I understand it, says we have no options for disposing of waste. And we know that under the licensing procedure, you cannot really license unless you can adequately address the waste issue. So this is a back-door way of limiting licenses of new plants, in my opinion. Rather than formally saying the administration is not going to license new plants, it is being done in an indirect way but not making available adequate waste disposal initiatives; therefore, the administration will not be able to license new plants.

It seems to me we are cutting off our nose to spite our face when we abandon nuclear or limit what is a genuine renewed interest in the use of nuclear, because nuclear is emission free and it is a hugely productive source of energy, already producing 20 percent of our electricity in this country. And compared to renewable electricty sources, nuclear dwarfs their capability of production. If you double the amount of energy that we produce in this country from wind and solar, which I would love to see us do, you still are only going to supply 4 percent of the Nation's electricity for consumption. If you double the amount of energy we consume from nuclear, you would get 40 percent of the Nation's electricity. This is very, very doable. All we have to do is support it with the resources on the loan side and have a licensing process which is reasonable.

So I want to hear specifically from the Secretary on the administration's position on nuclear. Are you for it or are you against it? If you are for it, how many plants do you plan to license in the next 4 years? And what is the timeframe for licensing? And what is the timeframe on coming up with a proposal on waste disposal?

I think this is critical to our ability to lessen our dependence on oil and to address the climate change issues which are so essential. So I look forward to the Secretary's testimony, and thank you for being here.

Chairman CONRAD. Thank you, Senator Gregg. And, again, Secretary Chu, welcome to the Senate Budget Committee, and we hope we have many more appearances by you during your tenure. And

we are delighted that you have accepted this position of responsibility. Please proceed.

STATEMENT OF HONORABLE STEVEN CHU, SECRETARY, U.S. DEPARTMENT OF ENERGY

Secretary CHU. Thank you, Chairman Conrad, Ranking Member Gregg, and members of the Committee. Thank you for giving me the opportunity to appear before you to discuss the President's fiscal year 2010 budget.

Before I begin, I have to also note that I spent 17 years at Stanford, and——

Chairman CONRAD. You know, I thought you looked especially bright.

[Laughter.]

Secretary CHU. And my wife spent 30 years at Stanford. She was the chief of staff of two presidents of Stanford, Dean of Admissions, although trained with a Ph. in physics. But, anyway—so I have divided loyalties. I am also very loyal to University of California-Berkeley.

The President's budget recognizes the enormous challenges and threats we face because of the ways we use energy. Today, as you indicated, we import roughly 60 percent of our oil, draining resources from our economy and leaving it vulnerable to supply disruptions. Much of that oil is controlled by regimes that do not share our values, further weakening our security. Additionally, if we continue our current rates of greenhouse gas emissions, the consequences for our climate could be disastrous.

If we, our children, and our grandchildren are to prosper in the 21st century, we must decrease our dependence on oil, use energy in more efficient ways possible, and lower our carbon emissions. Meeting these challenges will require both swift action in the near term and a sustained commitment for the long term to build a new economy, powered by clean, reliable, affordable, and secure energy.

The President took several strong steps toward that goal with the American Recovery and Reinvestment Act. As President Obama says, this act is putting Americans back to work doing the work America needs done. Let me highlight a few of its provisions on energy.

First, the Recovery Act will create new jobs making our homes and offices more energy efficient. It includes $5 billion to weatherize the homes of low-income families; a $1,500 tax credit to help homeowners invest in efficiency upgrades; $4.5 billion to "green" Federal buildings, including reducing their energy consumption; and $6.3 billion for State and local efficiency and renewable efforts.

The Recovery Act also includes $6 billion for loan guarantees and more than $13 billion in estimated tax credits and financial assistance instruments that may leverage tens of billions in private sector investment in clean energy and job creation. This will help clean energy businesses and projects get off the ground, even in these difficult economic times. The bill also makes investments in key technologies, such as $2 billion in advanced battery manufacturing, $3.4 billion for fossil energy research and development in support of clean coal efforts, and $4.5 billion for our efforts to modernize the electric grid.

Getting this money into the economy quickly, carefully, and transparently is a top priority for me. I know that your constituent States, localities, businesses, and other entities are eager to move forward and are seeking more information about how to access this funding. I have met with many of them already, and we will have much more detail in the coming weeks.

The President's fiscal year 2010 budget will continue this transformation to a clean energy economy, while returning to fiscal responsibility. The President has pledged to cut the deficit he inherited by at least half by the end of his first term. But even as we make the hard choices to begin to bring down the deficit, the President's budget will make strategic investments in America's economic future—investments that have been delayed for far too long. It lays the groundwork for our future prosperity by bringing down the high cost of health care, by giving all of our children a world-class education, and by reducing our dependence on foreign oil and creating millions of clean energy jobs.

The President's fiscal year 2010 budget provides $26.3 billion for the Department of Energy, with investments in basic science and in clean energy technologies, while securing and properly managing our Nation's nuclear materials. The development of this budget carefully considered the funding in the Recovery Act for the Department of Energy and complements those investments. The line-by-line details of the fiscal year 2010 budget are not yet final, but I would like to share with you a few of our priorities.

Investing in Science. The President has set a goal of doubling Federal investment in the basic sciences. As part of that plan, the 2010 budget provides substantially increased support for the Office of Science. It increases funding for climate science—a critical area of concern—and continues America's role in international science and energy experiments. The budget also invests in the next generation of America's scientists by expanding graduate fellowship programs in critical energy-related fields. The funding builds upon the $1.6 billion provided in the Recovery Act for basic science programs at the Department of Energy.

To encourage the early commercial use of innovative clean energy technologies, the budget supports loan guarantees to help these projects get off the ground. These include renewable energy projects, transmission projects, and carbon sequestration projects that avoid, reduce, or sequester air pollutants and greenhouse gases. It also provides support for research, development, deployment, and commercialization of biofuels, renewable energy, and energy efficiency projects. It also allows us to exploit our huge domestic coal resources with reduced harmful greenhouse gas emissions. The budget supports carbon capture and storage technology. This is in addition to the $3.4 billion provided in the Recovery Act for low carbon emission coal power and industrial projects. Together, these investments will reduce our dependence on oil and create sustainable green industries that will power our economy long into the future.

As part of the President's plan to modernize the Nation's electric grid, the budget provides support for the Office of Electricity Delivery and Energy Reliability. Goals of this program include improved energy storage, security, smart grid technology, and reliability. A

new smart grid will be more reliable, more secure, and quicker to recover from disruptions.

To enhance our security, the budget increases our efforts to secure and dispose of nuclear material and invests in innovative technology to detect and deter nuclear smuggling and weapons of mass destruction programs. Under this budget, development work on the Reliable Replacement Warhead will cease, while we will continue to make investments to ensure the nuclear stockpile's safety, security, and reliability. We will also improve performance and accountability for the environmental legacy of our Nation's nuclear weapons program.

Meanwhile, the budget begins to eliminate funding for Yucca Mountain as a repository for our Nation's nuclear waste. Both the President and I have made clear that Yucca Mountain is not a workable option and that we will begin a thoughtful dialog on a better solution for our nuclear waste storage needs.

For the longer term, the President has pledged to work with Congress to design a cap-and-trade system to reduce greenhouse gas emissions. Such legislation will place a market-based cap on carbon emissions and drive the production of more renewable energy in America. It will provide the framework for transforming our energy system to make our economy less carbon intensive and less dependent on oil.

Our energy agenda is an ambitious one, but it is the right one. We simply cannot afford to put off these investments any longer. But with the leadership of the President, the actions of this Congress, and the support and participation of the American people, I am confident that we will succeed.

Thank you, and I would be glad to answer your questions at this time.

[The prepared statement of Secretary Chu follows:]

Statement of

Steven Chu
Secretary of Energy

Before the
Committee on the Budget
United States Senate
Washington, D.C.

March 11, 2009

Chairman Conrad, Ranking Member Gregg, and Members of the Committee, thank you for the opportunity to appear before you today to discuss the President's Fiscal Year 2010 Budget.

The President's Budget recognizes the enormous challenges and threats we face because of the ways we use energy. Today, we import roughly 60 percent of our oil, draining resources from our economy and leaving it vulnerable to supply disruptions. Much of that oil is controlled by regimes that do not share our values, weakening our security. Additionally, if we continue our current rates of greenhouse gas emissions, the consequences for our climate could be disastrous.

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the ground, even in these difficult economic times. The bill also makes investments in key technologies, such as $2 billion in advanced battery manufacturing, $3.4 billion for fossil energy research and development in support of clean coal efforts, and $4.5 billion for our efforts to modernize the electric grid.

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allow us to exploit our huge domestic coal resources with reduced harmful greenhouse gas emissions, the budget supports carbon capture and storage technology. This is in addition to the $3.4 billion provided in the Recovery Act for low-carbon emission coal power and industrial projects.

Together, these investments will reduce our dependence on oil and create sustainable green industries that will power our economy long into the future.

Smart Electricity Infrastructure: As part of the President's plan to modernize the nation's electric grid, the Budget provides support for the Office of Electricity Delivery and Energy Reliability. Goals of this program include improved energy storage, security, smart grid technology and reliability. A new Smart Grid will be more reliable, more secure, and quicker to recover from disruptions.

Increased Nuclear Security: To enhance our security, the Budget increases our efforts to secure and dispose of nuclear material and invests in innovative technology to detect and deter nuclear smuggling and weapons of mass destruction programs. Under this budget, development work on the Reliable Replacement Warhead will cease, while we will continue to make investments to ensure the nuclear stockpile's safety, security, and reliability. We will also improve performance and accountability for the environmental legacy of the nation's nuclear weapons program.

Meanwhile, the Budget begins to eliminate funding for Yucca Mountain as a repository for our nation's nuclear waste. Both the President and I have made clear that Yucca Mountain is not a workable option and that we will begin a thoughtful dialogue on a better solution for our nuclear waste storage needs.

Cap-and-Trade System

For the longer term, the President has pledged to work with Congress to design a cap-and-trade system to reduce greenhouse gas emissions. Such legislation will place a market-based cap on carbon emissions and drive the production of more renewable energy in America. It will provide the framework for transforming our energy system to make our economy less carbon-intensive, and less dependent on oil.

Our energy agenda is an ambitious one, but it is the right one. We simply cannot afford to put off these investments any longer. But with the leadership of the President, the actions of this Congress, and the support and participation of the American people, I am confident that we will succeed.

Thank you. I would be glad to answer your questions at this time.

Chairman CONRAD. Thank you very much for that opening statement, Mr. Secretary. Let me begin talking about your basic philosophical construct as you approach the question of how we would reduce our dependence on foreign energy.

I have been part of a group that was dubbed by the media "the Gang of 10"—later it became a group of 20, evenly divided between Democrats and Republicans—that advocated a comprehensive approach to reducing our dependence on foreign energy, including increasing domestic production; dramatically ramping up conserva-

tion; a very strong investment in renewables, wind, solar, plug-in hybrid; an overarching goal of getting our transportation sector moved off of carbon-based fuels over the next 20 years; nuclear power, support for nuclear power was part of this. So the basic vision guiding this group was doing some of a lot of different things in order to dramatically reduce our dependence on foreign energy.

Could you give us how you see it, how you approach this problem? What is it that informed your decisions that you will be making?

Secretary CHU. Well, I have to say I agree with just about everything you said. Many approaches have to be used simultaneously. In terms of conservation of energy, that is—in terms of decreasing our dependence on foreign oil, that is the quickest thing we can do, improve CAFE standards, things of that nature.

The Department of Energy will be investing a great deal in battery technology to make plug-in hybrids a reality. Roughly 60, maybe 65 percent of the transportation energy we use is in personal transportation. Most of that personal transportation is 40, 50 miles or less per day. So if you can offload that demand and have access to other forms of generating energy via electricity, that would decrease our dependence.

I think biofuels has great potential; that is to say, biofuels, what I would call "fourth-generation biofuels," where we can take bio wastes—wheat straw, half the corn stover, lumber wastes, as well as very rapidly growing grasses that do not require that much energy input. There are estimates—for example, an Oak Ridge study that says there could be a billion tons of this material and converting a billion tons to 100 gallons of ethanol per ton will actually add a tremendous amount of roughly more than half of our current transportation needs.

So I think there is a real possibility for all of those things. So just go down the route, I think nuclear has to play a very important role in this century for our energy needs. The nuclear energy that can be generated, at night you can recharge your plug-in hybrid cars.

Chairman CONRAD. Let me ask you this, if I could. Another part of the effort was to support carefully thought through offshore drilling. Our group concluded, while that is no silver bullet, it is not going to solve the problem, nonetheless it is an important part of the mix.

Do you have views on offshore drilling?

Secretary CHU. Well, yes, I think if it is part of the mix, and realizing that it can play a role, but it really has to be part of a much more comprehensive plan. As you stated and as I said, we have to break our dependence on foreign oil, but we will be finding oil substitutes and decreasing our unnecessary use of oil. But there is part of the transportation sector—in airplanes, in long-distance trains, long-distance trucks—that for the near-term future we need liquid transportation fuels.

Chairman CONRAD. I have less than 3 minutes left. Let me just say we are asking everybody to have 7-minute rounds on the first round here today, a little more time than we had yesterday, because we are not backed up against a vote. So I want to get as quickly as I can to the questions that I have.

Coal. I come from the State of North Dakota. Most people think of that as an agricultural State, and indeed we are, and proud of it. But we are also a major energy State. Very few people think of us that way, but we are one of the major oil and gas producers, have major coal deposits. And I see this battle every night on television about coal, and some advocating clean coal technology, carbon sequestration, recognizing that 50 percent of our electricity currently comes from coal. I see these other ads running that say there is no such thing as clean coal and it is all a ruse and a farce.

What would you say to the American people, what would you say to this Committee and to the Senate of the United States with respect to coal?

Secretary CHU. Well, I think that coal again in this century will have to play a part of our energy mix. It is abundant. There are four countries that hold two-thirds of the known coal reserves. The U.S. is in No. 1. It has the largest reserves of coalalong with China, India, and Russia.

To my associates and friends who say that Americans should stop using coal, I would say we have to—I would counter that by saying we have to develop clean coal technologies because India and China will not turn their back on coal. And I do not think the United States will. And I think it is very possible that we can begin to develop these technologies aggressively so that we can trap a large fraction of the carbon emitted from these coal plants. It is a necessity given the fact that the world has incredible coal reserves.

Chairman CONRAD. I have just 30 seconds left. If I could just pursue that issue, what are the realistic prospects for carbon sequestration? Can you give us your insight there?

Secretary CHU. We need to pilot existing technologies simultaneously, existing technologies that can capture some reasonably large fraction, at least to get in parity with natural gas as a minimum.

Chairman CONRAD. And what would that be as a percentage, realistically?

Secretary CHU. A percentage of how much carbon? I would hope that we could capture 60, 70 percent at the start, and then do the research that brings into economic viability to go to 80, 90-plus percent. But I do not want to start by saying we have to begin with 90, 95 percent. So we want to get it going. We have to test technologies.

In the meantime, I plan to put a lot of money into research to test new ideas that could revolutionize, but the existing technologies we need to start piloting today.

Chairman CONRAD. Thank you.

Senator Gregg.

Senator GREGG. Thank you, Mr. Chairman.

Mr. Secretary, first off, I appreciate your allusions alluding to the fact that you do support nuclear as an option here. But I look at the constituencies who have been active in the Democratic Party, and many of them actively oppose nuclear power. My own experience in New Hampshire as Governor was that we were trying to bring online the last nuclear power plant licensed in this country, which was called Seabrook, and it took us an extra 15 years, cost the ratepayers in New Hampshire an extra $1 billion because of

the extremely aggressive opposition to the use of nuclear power, which was mostly affiliated with members of the Democratic Party in our State. And so I think there is at the core of the party that you represent a real resistance to using nuclear power, and we ought to be honest about that.

So my question to you: Is this administration going to support the licensing of new nuclear power plants? The Nuclear Regulatoroy Commission expect 22 applications for 33 units through 2011. Will any of those plants be limited in their ability to be licensed because the administration is no longer going to pursue Yucca—which I can accept if you had another option? Of the 33 units that are expected, how many will be licensed in the next 4 years?

Secretary CHU. OK. So I think I have been very clear since joining the Administration, and actually previous to that, that I believe that nuclear power is an essential part of our energy mix. It provides clean baseload generation of electricity.

In terms of the Yucca Mountain issues and nuclear waste, I think looking back at how that started——

Senator GREGG. I do not want to debate Yucca.

Secretary CHU. OK.

Senator GREGG. Because I accept the fact that Yucca may not be viable.

Secretary CHU. So what I intend going forward to do is begin to discuss with various people a blue-ribbon panel to say, OK, let us develop a long-term strategy that must include the waste disposal plant in order to go forward.

Senator GREGG. But are you going to limit the licensing of these 32 units until you complete this, as you called it, "thoughtful dialog"?

Secretary CHU. No, I do not—first, the NRC does the licensing, and——

Senator GREGG. Right. What will be the policy of the administration?

Secretary CHU. Well, I do not think the NRC should be limiting that or putting the licensing on hold, quite frankly, because the NRC has also said that we can put in the waste currently we now have and distribute it into dry cask storage. That dry cask storage could be safe for decades while we develop this energy. Within this year, we hope to develop a plan to move forward. So I do not see that as preventing going forward with aggressive licensing, quite frankly, but, again, that is the NRC's domain.

Senator GREGG. Will you be promoting additional lending authority—for example, $50 billion was taken out of the stimulus package—to assist in the construction of nuclear power plants?

Secretary CHU. I would actually be in favor of increasing—we have $18.5 billion. We are moving very aggressively toward getting that money out the door.

Senator GREGG. But that only will do three to five plants, so there was $50 billion in the pipeline that was taken out. Would you support putting that guarentee back in?

Secretary CHU. Well, let us just say I would support encouraging the nuclear industry to grow, at least. We are right now focused on starting the next generation of power plants, getting a generic

licensing of the Westinghouse and GE designs, and so you can accelerate that. You get, for example, the AP1000 license, and then a much shorter licensing period for a particular site. So we are working hard and helping get those initial generic licensing through the door with the NRC.

So I know you are a little bit suspicious, but believe me, I want to encourage this thing to go forward.

Senator GREGG. Well, I appreciate that, and I think your voice would be extraordinarily helpful because you are so highly regarded for your expertise.

Another question. You outlined a series of different sources where you could produce ethanol without having to put more in than you got out, to put it simply.

Secretary CHU. Right.

Senator GREGG. Switchgrass and other types of biomass. Doesn't the present subsidy structure of ethanol, which perversely promotes corn, undermine the ability to aggressively pursue those other forms of biomass?

Secretary CHU. No, I don't really think so, but let me also say that currently, with present technology, we don't have a cost-competitive technology of getting cellulose waste and grasses. But I actually have great hope that that will come about.

I have personally invested a lot of my time over the last four-and-a-half years at Lawrence Berkeley Lab. As you may know, Lawrence Berkeley Lab with UC-Berkeley and Illinois haveten a BP contract for converting cellulosic sources into not only ethanol, but more advanced fuels, and the Department of Energy has invested in three research laboratories, one centered in Wisconsin, one centered in Lawrence Berkeley Lab, and one centered at Oak Ridge, to create advanced biofuels.

The progress in those labs has been remarkable, even though they have only been in operation about 1 year. Berkeley Lab has already generated yeast and bacteria that can create out of simple sugars not ethanol, but gasoline and diesel-like fuel. And so they are now concentrating on getting that productivity up so it becomes commercially viable.

The reason BP has invested half-a-billion dollars in the University of California Berkeley Lab and Illinois is because they think it is actually a real possibility of a new business. So I am pretty optimistic.

Senator GREGG. That is good to hear. Natural gas—shouldn't we be drilling for a lot more natural gas in the United States? Our nation has the potential to tap into our huge natural gas reserves and we are always hearing about new ones being discovered across the country. Shouldn't we be more aggressively using natural gas and drilling for it, and drilling for it in the Outer Continental Shelf?

Secretary CHU. Well, I think natural gas is a very clean source of energy. Of all the fossil fuel energies, natural gas is the cleanest. It does have carbon emissions, but one of the concerns about natural gas is, partially like oil, is its extremly volatility. Yes, developing more natural gas in the United States should be part of a comprehensive energy plan.

Chairman CONRAD. Thank you, Senator Gregg.

Senator Murray? Let me just say the order on our side is Murray, Cardin, Warner, and Merkley. On the other side, Crapo, Alexander, Graham, Bunning, and Sessions.

Senator Murray.

Senator MURRAY. Thank you very much, Mr. Chairman, for holding this hearing.

Secretary Chu, good to see you again. Thank you for being here to testify and thank you for your willingness to take on this incredibly important agency. With everything you have had on your plate, I am not sure you had time to plan a trip out to my home State of Washington yet, but I wanted to reiterate my invitation to you to come and visit. Between Hanford and PNNL, we have a lot of facilities, I think, that you would benefit from seeing in person to understand their importance, and thanks to the Economic Recovery Act and the omnibus bill that we passed last night, the face and footprint of those facilities are going to be changing dramatically, so I again invite you to come out and see firsthand those facilities.

The Presidential priorities for clean energy really are exciting and I am delighted that we are looking at the future and how we need to plan for that. But as you and I have talked about previously, we can't forget our past as we look at our future, and clean-up is obviously not as flashy as some of the great new energy proposals out there and the other missions, but it has to be a priority of your agency and I want to make sure that we agree that the Federal Government has a moral and legal obligation to clean up those sites across the country and I need to know that you are with me when it comes to buckling down and focusing on the hard work of clean-up at the EM sites like Hanford, which is in my home State.

The funds that were provided in the Economic Recovery Act and in the omnibus bill that the President is going to be getting shortly were really designed to help us get back on track toward stable annual budgets, because we have seen 4 years of decline in these budgets and it has been an annual battle here that we should not be into. And I wanted to ask you this morning while you are here how you plan to buildupon the gains that we made for the EM budgets in fiscal year 2010.

Secretary CHU. Well, first, I think the Department of Energy has legal and moral obligation to clean up the cold war legacy. As you know, I argued within the Administration for substantial funds requested in the Economic Recovery Act, and so I was very pleased that we were given those funds and we are working apace at trying to deploy those funds as quickly as possible to really add a big kick to the clean-up obligations we have. I also am anticipating going to future stable budgets for that, and we are planning to come visit the State of Washington.

Senator MURRAY. Oh, you are? Great. Well, I am delighted. You are going to be at Hanford and CRPN while you are there?

Secretary CHU. I—well——

Senator MURRAY. You haven't made all those plans yet?

Secretary CHU. Well, certainly I will——

Senator MURRAY. We will help you plan.

Secretary CHU. You can help me plan.

[Laughter.]

Senator MURRAY. Good. I appreciate that.

Secretary CHU. That would be great if you could help us.

Senator MURRAY. OK. Fantastic.

Secretary CHU. You will be hearing from us very shortly, actually.

Senator MURRAY. OK. Great. Let me just say that the Economic Recovery Plan, whose focus is on the EM sites, needs nationwide to reduce their footprint so that we aren't paying the continual costs every year. It is very important.

But it is also important that we have stable budgets every year and we are working with the administration to get a funding level of $6.5 billion for fiscal year 2010 so we can continue the important work of doing the clean-up at those sites. So I hope that you will work with us as we move toward that.

Secretary CHU. I agree with you. Those are my goals. I should also say that I am spending a lot of attention on this money, to use it as wisely as possible. There have been in the past some cost overruns and we are taking steps in order to make sure—ensure that the projects are better managed both in the Department of Energy, and by the project managers on the sites. And so we are looking very hard at that. So it is not only the amount of money, but we want to raise the level—the effectiveness in which we use that money.

Senator MURRAY. OK. Well, we look forward to working with you on that.

Let me ask you about the national labs. I know, given your background, that those are very important to you. Washington State is the home to the Pacific Northwest National Laboratory. That is a very unique lab. I hope you have time to see it while you are there. It has a lot of diverse capabilities, from chemistry, energy, homeland security. It is actually home to EMSL, which is an Office of Science National User Facility, and PNNL is actually not only in Central Washington at the Hanford site, but we also have a site up on the Olympic Peninsula where we have the DOE's only marine science lab in the Nation and it is located in Sequim.

I know that you must be as pleased as I was that Congress funded the Department of Water Power Program at $40 million in the 2009 omnibus bill. That is a huge increase for that program and it covers many areas of water power research, from emerging water power technologies, like marine and hydrokinetics, to conventional hydropower.

The Pacific Northwest is a premier region for hydropower and continued innovation in that arena is critical, I believe. Can you talk to us about your vision of hydropower as we talk about the future energy use of the nation?

Secretary CHU. Well, I think hydropower is one of the cleanest sources of renewable energy that we have. I don't know to what extent—many people tell me that it is largely developed. I would actually like to see hydropower being used as pump storage so that we—this is using the electricity generated from wind turbines, from solar, to actually pump water back up into the dams and then to release it back into a holding pond below so that you can actually store the renewable energy. This is a technology that the world

is currently using and I see hydro, particularly in the Pacific Northwest, we have already begun discussions in the Bonneville Power Administration on how we can incorporate in an environmentally responsible way pump storage, because we will need storage mechanisms as renewable energy grows. So I think I am a big fan of hydro.

Senator MURRAY. OK. Great. And just quickly, in my last 30 seconds, I mentioned the Marine Sciences Laboratory at Sequim. They can be a real asset to your agency when you look at R&D. They are looking at a lot of really new technologies in our marine areas and I know when you come out to Washington State, it is a big State, you won't be able to get to everything, but I do hope the Marine Sciences Laboratory is a part of looking at some of this future energy. We have a lot of ocean out there that we can use if we have the technology to be able to use it.

Secretary CHU. Very quickly, I am not sure—the time is running out, but very quickly, I just want to say I do have a soft spot for the National Lab System. Actually, when I was at Berkeley as a graduate student post-doc, I was also an employee of Lawrence Berkeley National Laboratory during those 6 years and the National Lab System is an incredible asset to the country. I know the statistics better for Berkeley Lab, so at the chance of sounding more provincial, I would have to say that Berkeley Lab has trained over 30 young scientists—students, post-docs, young career scientists—who later went on to get a Nobel Prize.

Senator MURRAY. Wow.

Secretary CHU. I don't know what the number is of all the National Labs, but they are an incredible asset to our intellectual strength. Anything that will not only protect but enhance their capabilities, I am all for.

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

Chairman CONRAD. Thank you.

Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman, and Dr. Chu, I also welcome you here.

Before I get started on my questions, I just wanted to mention my disappointment, and I am sure you share it, over the incident that we were notified about last week concerning the loss of personal information of about 59,000 current and former employees at the Idaho National Laboratory. I know and I hope that your Department will continue to followup on efforts to protect the credit histories of those individuals and encourage you to do everything you can to make certain that we protect against this type of incident in the future.

I want to come back to nuclear, as you may have suspected. I strongly support the comments that have been made by my colleague, Senator Gregg, and by my colleague, Senator Murray, with regard to both the environmental management side of the issue as well as the advanced movement forward on nuclear power.

I know you have already indicated your support for nuclear power. I wanted to point out that, as you are very well aware, in August of 2008, when you were the Director of the Lawrence Berkeley National Laboratory, you, along with the other directors

of our National Labs, signed a report called "A Sustainable Energy Future: The Essential Role of Nuclear Energy," and Mr. Chairman, I would like to submit a copy of that report for the record.

Chairman CONRAD. Without objection.

Senator CRAPO. Thank you. And the reason I wanted to do that is simply to make sure that the record shows the strong support that exists for nuclear power as a key part of our national energy policy.

Senator Gregg has talked about the need to focus on making sure that nuclear power is treated properly in the budget and that we focus on the loan guarantees and the licensing. That report also laid out a very aggressive nuclear R&D agenda that covers both sustaining the current reactor fleet, closing the nuclear fuel cycle, and expanding our nuclear power's reach beyond electricity.

My question to you is, these R&D activities require much significant funding and I think they will have a tremendous return on investment. But are you and the administration committed to properly funding these R&D activities?

Secretary CHU. The simple answer is yes. I stand by what I signed several years ago. As I said, I have a record of saying that nuclear has to be part of our energy mix in this century. I think closing the fuel cycle is something we do want to do. We do not know how to do it in its present form. I am worried about its proliferation potential and we should work hard at closing the fuel cycle to make it more proliferation-resistant.

But in the long term, I think ideally it would be a good step for several reasons. It has the potential for greatly reducing the amount of nuclear waste, with a small percentage of reactors having high-energy neutron flux that you can burn down the long-lived—actonize the waste material. That would mean that you would have to store stuff for a million years, you can reduce it to hundreds of years, so there is that potential. So both the advanced nuclear reactors that can do this, and that is why we have to take a fresh look at the nuclear waste repository strategy, as well. It is all incorporated in the strategy, which include research into making fuel cycling, recycling, a reality.

Senator CRAPO. Well, thank you. I appreciate that. There has been—as Senator Gregg indicated, there have been sort of some subtle signals, maybe just in the sense of lack of attention to the role that nuclear power can play in what we have seen already that have raised concerns, and so I hope that as we move forward and get specifics on the budget proposals, we can have a much more full explanation of the support for this kind of R&D.

I would like to also go to the Yucca Mountain decision. I am very discouraged by the decision that has been made by the administration with regard to Yucca Mountain, and you indicated in your response to Senator Gregg that one of the things that could be done while we were trying to figure out where to go now is dry cast storage.

As you are probably aware, that is not going to help Idaho. Idaho is the location of a significant amount of spent nuclear fuel that was not generated in Idaho, and the Federal Government has a binding agreement with our State to remove that nuclear fuel by 2035. It takes a long time. If you are going to shift from Yucca

Mountain now, I suspect that just simply putting the material into dry cast storage is—I know that that is not a solution for the agreement that the Federal Government has with Idaho and that we are going to probably look at a very long timeframe of whatever the next option you may come up with is.

And so I guess the question I have to you is how will you resolve the issues in terms of managing the spent nuclear fuel at Idaho and the Federal Government's obligation to take possession of that fuel?

Secretary CHU. Well, we do have an obligation. My understanding is by 2035, it should be ready to ship out. I am hoping after—I don't want to prejudge what this blue ribbon panel might determine, but again let me reiterate this will be done this year, that we can move in a way that would not take as long as the previous experience.

Senator CRAPO. Well, I hope you are correct about that, and frankly, a lot of research that is being done at the Idaho National Lab, as you have just indicated, could help to be a part of that solution.

Secretary CHU. Right.

Senator CRAPO. And although I am very discouraged in the decision that we have seen, I think we need to get very aggressive at finding a path forward.

I have a couple of other questions. I have about a minute left. One question I had is as we were doing the—pursuing the stimulus package, one of the provisions that was in it was a manufacturing tax credit, which again talked about a lot of different forms of energy but it did not specifically mention nuclear energy. As we revised the bill on the floor of the Senate, we were able to change the language there, not to mention nuclear specifically but to give the authority to the Department of Energy to include nuclear power in that manufacturing tax credit. I just wanted to make sure you were aware of that and also to receive your assurances that nuclear power will be able to receive that manufacturing tax credit as we move forward.

Secretary CHU. I am not actually aware of the exact details, but I will certainly look into it, and if it is allowed, they will certainly be eligible.

Senator CRAPO. All right. Well, thank you very much.

One last question. In President Obama's fiscal year 2010 budget request, he assumes 100 percent auctionable allowances under a cap and trade legislation proposal. Twenty percent or $150 billion over 10 years is directed to clean energy technologies, including biofuels, renewable energy, and so forth. Can you expand a little bit on what clean energy technologies will receive funding from this proposal and whether nuclear energy will be included there?

Secretary CHU. Again, I am not sure of the exact statutes, but let me tell you what I understand it is going to be. Biofuels is an example. Clean energy biofuels is what I call fourth generation biofuels, where you put in far less fossil fuel inputs into the lifecycle generation costs. Advanced batteries—we do not have batteries that can last 15 years of deep discharges, that we need probably a factor of two or three higher energy densities before I could see a massive deployment of plug-in hybrids, and then even a bet-

ter battery for all-electric vehicles. Those are examples of clean energy technologies.

Senator CRAPO. Would nuclear be included, in your opinion?

Secretary CHU. I would have to look again at the statute, quite frankly. Nuclear is—we have still a nuclear waste issue we have to overcome and we have—but, you know, if you look at the palette of our basic electricity now, it is gas, it is coal, it is nuclear.

Senator CRAPO. Well, thank you. I see my time has run out.

Chairman CONRAD. You kind of snuck an extra one in on me there.

Senator Cardin.

Senator CARDIN. Well, Mr. Chairman, first, thank you for holding this hearing, and Secretary Chu, it is a pleasure to have you before our committee. I also add my thanks for your willingness to serve our nation in this critical role.

Our energy policy needs to achieve two objectives: One, energy independence, so we are not as dependent upon foreign sources of energy; and two, we need to deal with the global climate change and greenhouse gas emission issues. So let me first deal with the environmental issues. I want to congratulate the administration for including the cap and trade proposal in your budget.

Our energy policy can make us more secure, it can help our economy, and it can also improve our environment and make America a leader internationally. A cap and trade system establishes a specific goal on carbon reductions and I think that is perhaps its greatest strength, that we know on a particular day we will hit particular goals.

It also, with the trade system, allows market forces to work. We would have the capability of looking at vulnerable consumers and making sure that they are held harmless or that we deal with the adverse impact of a carbon cap on their logs. So it gives us that capacity. But we have to get it right. We want to make sure the market forces work and that with whatever rebates we provide or however we use the revenues, we don't injure the concept of allowing the market to determine energy sources in the future.

I want to underscore one point. Cap and trade is going to be friendly toward nuclear power because the carbon footprint on nuclear energy is rather modest. And to my friends who seem to think this is a partisan party issue, in Maryland, we are moving forward with a new reactor because we need it in our State. We have a Governor who is a Democrat who supports this and our delegation supports this. We definitely believe that nuclear is part of America's goal to become energy independent and to be friendlier toward our environment.

But we also need the revenues to invest, and I have heard my friends talk about certain investments that we need. We do need to invest in the next generation of nuclear. We need to figure out how we are going to deal with clean-burning coal as part of our energy solution in this nation. And we need to invest in new technology. So we need to get it right, and the revenues from the cap and trade would allow us to do that.

Last week, we had the opportunity to meet with your counterpart from Great Britain and he made a very interesting observation. He said the fact that Europe and England moved forward unilaterally

on climate change legislation was good for their economy. They weren't so concerned about what other nations were doing other than the international impact, that we all have to be together on it, but that this was good for the economy of Great Britain.

Yesterday this Committee talked about getting health care costs under control, because the long-term impact on our economy if we don't would be devastating. We can talk about deficits all we want. If we can't control health care costs, it is going to be very difficult for us to deal with budget deficits in the future. If we don't deal with energy issues, the impact on our economy could be severe. So I would ask you to comment as to how, if we get this energy policy right, it is going to create jobs for our economy and help us grow.

Secretary CHU. Well, I agree with you and I agree with the British minister. I liken it to really identifying something that is a common challenge not only in the United States, but across the world, regarding decreasing our emissions on carbon, that this is a cause that all the world should be investing heavily in.

And so what do we invest in? Well, we invest in, in the near term, weatherization of homes, but we invest in how to develop buildings, commercial and residential buildings that are much more energy efficient. Those investments go into the country where those buildings will occur. When we do that, what we are really doing when we spend roughly 40 percent of our energy in buildings, we will off-load that expense. I mean, a lot of that purchase of dollars in paying for utility bills just goes up the smokestack.

And so what we are doing is we are rebuilding infrastructure that in the new world, where energy costs will be seen on the long term to increase and we recognize the new 800-pound gorilla in the room is climate change, and so while we are investing to try to mitigate the more severe predictions that might occur, you are building an infrastructure that is much more efficient so you don't spend as much——

Senator CARDIN. I hope that our investment includes public transportation, because if we can get people to work quicker and friendlier, I can tell you particularly in this region, it will be good for our economy and result in less stress for the people who have to confront traffic problems here in the Washington region and around the country.

I want to move on to energy independence for a moment, because you are specific about your goals on the environment. You are not quite as specific on energy independence. I encourage you to establish reasonable goals as to how we can wean ourselves off of imported energy sources, particularly oil. We should also have a way of judging whether we have reached those goals, and using, as the President announced last week, the best science we have available to achieve those goals. Third, we need to know what policies Congress should advance to assist in that regard. I urge you to have some mechanism to achieve that.

Some of us in Congress have offered suggestions. We look forward to working with you. We need to be able to judge how we are achieving energy independence. We have been through this many times before and we didn't achieve great results. Let us make sure we get it done this time.

Secretary CHU. I think there are very specific goals. It is a double-barreled thing. You use less and you create more transportation fuel on shore. But biofuels is a large part of that——

Senator CARDIN. But what I am saying is that we need specific goals as to how much oil we will have to import next year, 5 years from now, 10 years from now, and hopefully at some point, zero, and we must have in place mechanisms to ensure that we achieve those goals.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Cardin.

Senator Alexander.

Senator ALEXANDER. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. First, I want to thank you for your work on the America Competes recommendations to Congress, which I hope you find as a very useful blueprint over the next few years and I hope we can properly fund it.

Second, I want to invite you, as I know you will, to come to the Oak Ridge Laboratory, particularly because of the renewable energy work there in which you have been very interested the last few years and its alliance with the University of Tennessee on science matters. I think you will find that especially interesting.

Without being presumptuous, I would like to suggest a way that you could win another Nobel Prize or someone could, and that would be to find a way to capture and deal with most of the carbon after it has been burned in existing coal plants. You made some reference to this the other day in your Energy Committee testimony. You talked about post-combustion technologies needed to meet the climate challenge.

I think you could understand some of the skepticism around the table about the administration's goals when it comes to nuclear and coal. My friend and fellow Tennessean Al Gore can write a whole article about reaching low-carbon goals in the next 10 years without even mentioning nuclear power. And in his article in the New York Times in November, which sounded like a blueprint for the Obama administration, he said that the idea of recapturing carbon from coal was so unrealistic as to be imaginary. Do you agree with that?

Secretary CHU. Well, golly, you are going to put me on the spot to disagree with my friend, Al Gore——

Senator ALEXANDER. Well, he is my friend, too, but that doesn't mean he is always right.

Secretary CHU. Let me just say that I think there is a lot of ingenuity out there that we are going to have to try, and I think there is a reasonable chance of success, quite frankly, in capturing a large fraction of the carbon emitted from coal-burning plants. I want to say that we have to try to do this because no matter what the United States does, India and China will not turn their back on coal. They are building pulverized coal plants, conventional coal plants——

Senator ALEXANDER. Yes.

Secretary CHU [continuing]. One a week are the numbers I am hearing. So if we don't develop this technology, who will?

Senator ALEXANDER. Well, there are strong environmental groups who agree with that point. I mean, the Natural Resources

Defense Council makes that point. And let us forget carbon for the moment, but we have sulfur and nitrogen to think about, as well, and it goes up in the air in India and we breathe it in Los Angeles and Tennessee. So a gift to the world, it seems to me, would be during your time as Energy Secretary to find a way to get rid of carbon, which is the only remaining pollutant in coal that we don't know how to control.

Let me press that a little further. All the talk is about carbon sequestration and sticking it under the ground. I am not a scientist. That seems unlikely to me for such a large amount of carbon. Isn't there more likely to be some biological or chemical process, such as the algae experiments we have heard about, that might produce a way to burn coal from existing plants and get rid of it?

Secretary CHU. First, there have been experiments going on now in geological sequestration of carbon, a couple million tons a year in a few locations. I am not skeptical, quite frankly. I think it has to be done right. It has to be monitored for safty in order to gain the confidence of the American public.

But we are looking at all sorts of ways. Algae is one of them. The downside of algae, quite frankly, is that you need a tremendous amount of surface area in order to capture a large fraction of the carbon dioxide, where, you know, you pass it over algae——

Senator ALEXANDER. But you also do for solar thermal power plants, if I am not mistaken. You have acres of mirrors.

Secretary CHU. That is true, so the issue here then is you would have to port that carbon—the coal plants are more centralized in higher populated areas, and so you would have to imaging porting that carbon dioxide out of the cities where the coal plants are to some distant location.

But we will be looking at all of these avenues. We will further be looking at avenues in which you can grab carbon dioxide out of the air. Plants do this, and we will be looking at ways in which we can apply that. A plant grabs carbon dioxide out of the air and it grows into some biomass type of thing. Now, when it is used, either it is burned or when it just falls and decays, the microbes recycle virtually all of that carbon back into the atmosphere. A small fraction—

Senator ALEXANDER. Well, I am very encouraged that you are in the position that you are and to hear your testimony. It seems to me that so much of our discussion about climate change and clean air comes down to a carbon tax and renewable energy. And even if you are for both those things, given the size of our economy and India and China and what they are doing, it seems to me that sometimes we overlook the easiest ways to solve the problem. You have mentioned one, which is conservation and efficiency. To give Gore a little credit, he says that 40 percent of carbon comes from buildings. Well, we can probably agree on what to do about that. But right after that comes nuclear. No one has mentioned this figure today, but it is 70 percent of our carbon-free electricty, so how could we even think about dealing with climate change without involving nuclear power? And if coal is half of our electricity and it is American and it is low cost and we have more of it than anybody and we are helping the world, it would seem to me that a mini-

Manhattan Project on carbon capture, as the National Institute of Engineering has recommended, would be a terrific goal for the new Secretary of Education.

Secretary CHU. How about Energy?

[Laughter.]

Secretary CHU. I agree——

Senator ALEXANDER. I mean Secretary of Energy. I am sorry.

Secretary CHU. I agree. I agree with all the things you have said. I would love to invest more in carbon capture and sequestration of all kinds and taking the carbon from coal plants and turning it into cement and using the cement. It is going to be——

Senator ALEXANDER. Do you plan to use the new ARPA-E, the Energy Department form of DARPA, for such things as making solar power costs competitive, finding ways for carbon capture, advanced biofuels, nuclear waste reprocessing? It seems if you had four little mini-Manhattan Projects to deal with those four things at ARPA-E in the next 5 years, that would transform the world's energy picture.

Secretary CHU. I would love ARPA-E to invest in all of those things. And as you know, we are planning to stand it up.

Senator ALEXANDER. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I would also like to add my congratulations to Dr. Chu, and thank you for taking on this terribly important challenge.

Let me first of all associate, before I get to my questions, with the comments of both Senator Cardin and Senator Alexander. I share, like Senator Cardin, the belief that nuclear power has to be part of the mix. We in Virginia, like Maryland, are one of the States that is further along in terms of adding new reactor capability, and clearly we have disposal issues, but I do hope it is part of the mix.

Echoing what Senator Alexander said, I also believe, as I think you appropriately pointed out, should America move away from coal, India and China are not. So the Holy Grail is getting a cleaner way to grapple with coal, and I would simply point out, perhaps for your staff's review at some point, if we could do it post-burning, great; but if the sequestration option is still out there, we have a brand-new, next-generation coal plant being built in southwest Virginia where there are wonderful geological formations in terms of the ability to sequester. And I cannot think of anything better than eastern Tennessee, southwest Virginia, West Virginia, places in Appalachia, along with Pennsylvania, that started the industrial age in America that developed the coal to actually have the solution set come from that region as well. So I would urge you and your staff to take a look at that facility as a potential beta site for a sequestration project.

Let me come back to one of my favorite topics, and that is, how we are going to make sure that all that is on your plate is going to be done efficiently and effectively. I am very excited about all the options that came out of the recovery plan: your weatherization activities, the smart grid, the green buildings, the loan program.

The challenge, though, that I think you have is: As you use these assets, how do you get them out quickly, create jobs, and at the same time scale up these programs effectively? One of the things that I was happy to see that you did that I would love to see other secretariats do is I understand you hired a former McKenzie guy—I believe his name is Matt Rogers—to look at this. And I would like for you to describe what Mr. Rogers' portfolio will be on how we set up, not just from an Inspector General looking back standpoint, but how do we make sure on the front end of these programs and projects we get it right in terms of protocols, procedures, and make sure that there is going to be appropriate financial oversight.

Secretary CHU. Well, yes, thank you for giving me this opportunity. Matt Rogers is wonderful. We have streamlined our processes, completely overhauled how we try to evaluate and get loans out the door. He is directly reporting to me on all the economic recovery work that is——

Senator WARNER. So he will not just be doing the loan portfolio? He will also have——

Secretary CHU. He is part of——

Senator WARNER [continuing]. Oversight of all of the Recovery Act?

Secretary CHU. Auto, everything. And what is happening is that he meets every day at 9 a.m. with the people in the Department of Energy: What has been done today? And they have to report, and it has actually transformed the way the Department of Energy is moving forward. And so we are hoping to announce within weeks the first tranche of these loans.

We are also looking very much to your question about how do you do this effectively, that you prevent fraud, abuse, inefficiency. And so we are working with the internal DOE IG, also with the administration IG, not to—you know, they viewed themselves perhaps in the past as an audit function to look into things where there might be a suspicion of waste or abuse, but to actually anticipate what might go wrong and start to plan as we get these things out and how to monitor. So now they are becoming an integral part of the planning process. As we release the money, we will be releasing it in stages and will be looking very closely, because whenever there is a new flood of money, there is always a potential for it not being spent in the wisest way possible.

So, again, this is a daily thing. I realized very quickly—in fact, in my first week—within starting that I needed someone who is very, very good, who could help the Department of Energy respond in a way, because we cannot fail on this.

Senator WARNER. I commend you for doing this, but I do not think some of your other colleagues who have equal challenge, particularly with the Recovery Act funds, have put in place this same kind of oversight. And I would love to see if you could perhaps share with this Committee what kind of protocols across sectors have been developed, because I think we need to make sure that it is not just kind of "look back, gotcha," but we actually spend this money efficiently going out.

Secretary CHU. Right.

Senator WARNER. That brings me to the second part of my question, which is, when we think about literally training up thousands

of folks around weatherization, or as we look at how we are going to develop the smart grid initiatives, a lot of these resources are going to still be passing through the States. And I hope that one of the things we have to do is start with common definitions. And my concern, as I raised with Dr. Orszag yesterday, is that we have a goal of job creation, but if Tennessee counts job creation differently than Virginia and differently than Alabama, we are not going to have common standards.

Have you or Mr. Rogers looked at, as you drive these programs down into the States, making sure that we have common standards across the various States?

Secretary CHU. Yes. In fact, there are two parts of the question: first, common standards; but, also, there is going to be a huge need in the weatherization program for competent, trained, certified energy auditors. So you establish a baseline. You have to actually go in a home and tell the homeowner what is the best way to invest money. It is one thing to create jobs, but we also simultaneously have to make sure that that actually decreases energy bills in a substantial way.

And so we have already engaged in associations around the country, groups of mayors, and are pointedly asking them, as part of how we get out there, get the money out there, to, you know, let us know what your training programs are for these auditors, how you are actually going to ensure that this money is well spent.

Our job does not stop by just releasing the money to States, and the President has made that very clear to all the Cabinet members.

Senator WARNER. Well, I think you are going to find a lot of these programs you are going to want to continue, and even my colleagues that might not have supported the Recovery Act, they are going to want to make sure, as I, that we have real accountability methods. Doing this on the front end is terribly important.

My last point—and I know my time has expired—Senator Alexander also raised the issue of algae. Algae has wonderful opportunities in terms of as a biofuel, and I would commend your staff, again, to look at some of the research that is going on at Old Dominion University in Virginia on that issue. Thank you, sir.

Thank you, Mr. Chairman.

Chairman CONRAD. You bet.

Let me just say to my colleagues, we kind of have an issue now because we have a little less than 50 minutes left, and we have nine Senators. I propose we go to 6-minute rounds unless anybody has a big problem with that.

All right. Let us do that. Senator Alexander—Senator Graham. I am sorry. Senator Graham is next.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Secretary, your testimony, quite frankly, has been more reassuring than the budget and, quite frankly, it has been more reassuring to me than the President's speech to the Congress a couple of weeks ago in the area of nuclear power.

But one thing I have learned from being from a State that has a national lab and Savannah River site, where we have a big DOE footprint, is that the politics around energy are sort of like agriculture politics. They do not break along party lines many times. You have two Senators on the other side who have talked about

nuclear power as being part of the mix in their State. And I have had my problems with the last administration with environmental management funds, sort of stopping programs in the middle. And so, one, I want to applaud you for beefing up the environmental management budget so that people like South Carolina's Savannah River site, who have done some pretty aggressive things to reduce their waste footprint, will not be left hanging. And so the more certainty, the better.

But, quite frankly, what has been disturbing is that in the nuclear power arena, the $50 billion to support a more aggressive loan guarantee program was taken out of the stimulus package. Do you know why?

Secretary CHU. No, I do not.

Senator GRAHAM. OK. Now, when the President spoke to the Congress a couple of weeks ago, he mentioned energy independence and climate change as two big issues for the administration, and he gave a list of solutions. He did not mention nuclear power. Do you know why?

Secretary CHU. No.

Senator GRAHAM. OK. When it comes to the fuel cycle, are you familiar with what the French and the Japanese are doing in terms of recycling spent fuel?

Secretary CHU. Yes, I am. They are using a technique the United States invented.

Senator GRAHAM. OK. Why aren't we using it?

Secretary CHU. Because of the concerns of proliferation, and they are becoming increasingly concerned as well.

Senator GRAHAM. Well, as I understand it, the Japanese just developed an $18 billion recycling—do you think their programs are reckless?

Secretary CHU. Well, quite frankly, I would have preferred if they—they are talking to us now about a second recycling where they want to develop a more proliferation-resistant one.

Senator GRAHAM. Of all the European nations, what nation has met its carbon emissions targets?

Secretary CHU. Well——

Senator GRAHAM. What is the only one?

Secretary CHU. I think Great Britain has, but I may be wrong.

Senator GRAHAM. I think it is the French.

Secretary CHU. OK.

Senator GRAHAM. Eighty percent of their power comes from the nuclear power industry. And what I am concerned about is that if you are serious about climate change, there are a couple things you have to realize. It is never going to happen unless it is bipartisan. It is never going to happen unless there are some costs associated with going from carbon to something else. And the number in the budget is $646 billion. That is the revenue to be generated from the proposed cap-and-trade system the President has announced.

How did we arrive at that number?

Secretary CHU. Pardon? How did we arrive at what?

Senator GRAHAM. The $646 billion in the budget set-aside as a revenue stream from the cap-and-trade system.

Secretary CHU. The details of that I do not know.

Senator GRAHAM. OK. A hundred percent auction of the credits.

Secretary CHU. Right.

Senator GRAHAM. My concern——

Secretary CHU. Oh, sorry. I misunderstood your question.

Senator GRAHAM. I am sorry.

Secretary CHU. The money was, yes, going to come from the credits. The exact amount or the estimate, I did not know.

Senator GRAHAM. Well, somebody has to assume that a credit will trade at a certain amount to generate $646 billion. I would like to know the formula they used. If you could get that to me, I would appreciate it.

Senator GRAHAM. The one thing that disturbs me about the climate change proposal in this budget and the President is pushing is that 100-percent auction of the credits will, I think, make it very difficult for a heavy-energy-user manufacturers all over the country—Michigan, Ohio, South Carolina, and other places—to basically stay competitive in a global world, because their competitors in China and India are not going to have to deal with this issue, and I believe hedge funds are going to jump into this arena and affect the auction system to make it very difficult on manufacturers who employ a lot of Americans to stay in business.

Is that a concern of yours?

Secretary CHU. It would be a concern of mine if hedge funds jumped into anything at this point in time.

[Laughter.]

Senator GRAHAM. OK. No, I understand, and I do not mean to put you on the spot, because I have a lot of hope that you will really be good for the country here. But the 100-percent auction is a departure from other legislation that has been proposed that I think is going to make it very difficult for American businesses who are hanging by a thread in a global economy to comply. And when you take the revenue stream and you put 15 or 20 percent of it into clean energy and you cannot tell me nuclear power is part of it, that is disturbing. And when the rest of the revenue stream I going to pay for a "Make Work Pay" tax program that I think is divisive, I think what we have done is destroyed the ability of the Congress to come together, because 100-percent auction is a radical departure from the way we have set up other cap-and-trade systems that Democrats and Republicans have bought into. And dedicating the revenue stream to pay for a tax plan that is divisive is going to make it more difficult to find consensus on climate change. And the money going back into the energy sector that you cannot tell me includes nuclear power is even going to undercut more the ability to solve the climate change problem, because I do not believe, quite frankly, Mr. Secretary—and I think you probably agree—that you can be serious about climate change solutions unless you aggressively pursue nuclear power as part of the mix.

So that is more of a statement than it is a question, but at the end of the day, I have a lot of hope that we can find consensus on this issue, and I would urge you to talk with the Chairman about his Gang of 10 proposal. I think it is very creative and it is very bipartisan.

Thank you.

Chairman CONRAD. I thank the Senator.

Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and I thank you for your testimony, Mr. Secretary.

The administration has set out a long-term carbon dioxide goal of 83-percent reduction by 2050, and I believe the number on the shorter term is 14 percent by 2020. There are a number of folks in the scientific community who have said we need to be more aggressive as a community of nations in the short term.

Is the administration locked into this goal of 14 percent? Are they looking at strategies that might hit—I think the common number is 25 percent globally by 2020. Is that a piece of the conversation about how aggressive we are in taking on global warming?

Secretary CHU. I think the Administration so far is just repeating what the campaign promises were. There are two numbers: 20 percent by 2020 and 25 percent by 2025. I would personally be delighted if we can reach, you know, 20 percent by 2020. But we also need to get there, and so, you know, I mean, my heart is trying to get as much as we can out of it as quickly as possible.

Senator MERKLEY. Well, as we look at the variety of technologies—and people have spoken to various components of non-carbon technologies or capturing carbon or taking and preserving—using energy more efficiently, which is another strategy for reducing carbon. As one ranks these, what is the most cost-effective strategy, or how do these lay along the curve under current technology?

Secretary CHU. There is no question that energy efficiency and conservation is the most cost-effective strategy. As I am sure you know, in the McKenzie report a lot of the carbon decrease, the carbon abatement will come in the form of saving money if done right. And so there is no question in my mind in the coming decades most of the decrease in the carbon dioxide will actually—should and must come from energy efficiency and conservation. That is the lowest-hanging fruit on the ground by far.

Senator MERKLEY. How do the other technologies rank?

Secretary CHU. Well, let us say that it—I am thinking now down the list of things. You know, better management, the development of renewable resources is kind of in the middle. The efficiency is definitely the highest ranking. Better land use management is part of that mix.

Senator MERKLEY. Let me be a little more precise. We had a discussion of solar and wind and nuclear. Is there a fair sense of how those rank in terms of the cost?

Secretary CHU. Again, it is based on today's technology, and what we have——

Senator MERKLEY. Based on today's technology.

Secretary CHU. Right, based on today's technology, I think that wind is more cost-effective than solar photovoltaic or solar thermal, which is more cost-effective than photovoltaic. So is that sort of—and nuclear is a very—well, the full costs of nuclear, you know, are complex, especially in this waste management issue. But nuclear is in there as being more cost-effective than photovoltaic at the present time.

Senator MERKLEY. When you take into account the entire life cycle of nuclear?

Secretary CHU. Yes, but it is——

Senator MERKLEY. I am surprised, because I think the reports I have seen have said that solar is almost half the cost of nuclear when you look at life cycle costs of generation.

Secretary CHU. There is a little bit of an uncertain in my mind about what the life cycle costs of nuclear are, especially since we do not have in place a long-term plan for how we handle the waste.

Senator MERKLEY. All right. You mentioned the issue of the impact of reprocessing technologies upon nuclear proliferation. Of course, we are dealing with North Korea. We have a situation in Pakistan with an unstable government that has at least 30 nuclear weapons. Can you expand on the point you are making about how reprocessing ties into nuclear proliferation?

Secretary CHU. Yes. The current reprocessing technology, the so-called EUREX technology that France is using, Japan is beginning to use, actually separates out the plutonium, and once you separate out the plutonium and you have this material around, it offers the possibility that terrorists, for example, can get their hands on this stuff. That is the proliferation problem.

Senator MERKLEY. We are asking a number of countries around the world to forego reprocessing for that very reason. Does it create a challenge for us diplomatically if this is the strategy that we are pursuing here in the United States?

Secretary CHU. Well, it is not the strategy we are pursuing in the United States. We are pursuing a strategy where we——

Senator MERKLEY. But if were pursuing that strategy. You had mentioned the possibility that you were considering the——

Secretary CHU. We are considering recycling, but considering recycling in a way that makes it proliferation resistant. So you do not create the pure plutonium. You actually put in other stuff, for example, that makes it less likely that you can make a nuclear weapon, quite frankly, much more radioactive so that it protects itself.

Senator MERKLEY. So it is too dangerous to steal.

Secretary CHU. That is right, that it would kill the terrorist within a very short time.

Senator MERKLEY. Plug-in hybrids—I am out of time, but in the future, I would like to pursue that issue with you. Thank you.

Chairman CONRAD. I thank the Senator.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. Welcome, Secretary Chu. I would like to get to cap and trade because Senator Crapo asked some of the questions I was going to ask about nuclear. I have a son who has been working in nuclear power for 25 years, first with the United States' Navy and now for a power company. The Navy has been very successfully and very efficiently in the way that they operate their nuclear facilities, and they store onsite their spent uranium and things like that, which is required right now since we do not have very many depositories to send it to.

Do you think that large-scale carbon capture and storage will be in use at any coal-fired plants by the year 2012? Do you expect any new nuclear to be online by 2012?

Secretary CHU. Commercially, I think the answer is no to the first. There will be, I hope, pilot plants and tests, near-commercial-

scale tests of carbon capture and storage by 2012. Nuclear power plants, this is up to the NRC. People tell me starting today, 2012, to actually have a plant licensed and operating, unlikely.

Senator BUNNING. OK. If that is the case, then why is your administration proposing that we dedicate less than 20 percent of the auctioned revenues from this assumed cap-and-trade program to emerging technologies in clean coal and renewables and over 80 percent of its tax credit that not every citizen and certainly not every small business will qualify for?

Secretary CHU. Well, when you have a cap-and-trade system, it will have impacts, and there is a sensitivity with the poorer people in our country, and so there was a decision made that a certain fraction of it would try to offset the impacts. But a significant amount of that would be for investing in the development of new technologies so we can get it out there faster.

Senator BUNNING. Thank you for bringing that up, because in my home State of Kentucky, 93 percent of our electric comes from coal, with 20 percent of my State's residents falling below the national median income. Can you tell me what the estimated increase in the cost of electricity would be in my State if the renewable portfolio standard in its current draft form went into law?

Secretary CHU. No, I cannot precisely tell you. I have heard estimates, for example, that there is a DOE study that showed if we get to 20 percent wind, it would increase the cost of electricity around the United States by less than one-tenth of one cent per kilowatt hour. I just do not——

Senator BUNNING. Well, first of all, we have to have the technology to store the wind. Then if you produce the wind in South Dakota, how do we get it to Kentucky? Or else will the residents of my State have to pay a tax that would not be very favorable and would be not offset by the fact that you are going to charge me for producing electricity from coal and I am going to have to worry about how you transmit your wind energy and your solar energy because the technology does not exist presently, to store it.

Secretary CHU. The technology—aside from pump hydro storage, I would agree with you, Senator. This is something we have to be investing in. But 20 percent will not really, in my opinion, require massive energy storage. That can be solved by a distribution system, which we need to develop concurrently.

Senator BUNNING. Yes. How many years down the road would that be?

Secretary CHU. It would take a couple of decades to really flesh out, but we have to begin today.

Senator BUNNING. I do not disagree with you. I think that is absolutely essential. But to get from Point A to Point B, you cannot eliminate coal and you cannot do anything but clean it up. If we are going to have a global cap and trade, and we are going to exclude China and India from the global cap, we could clean up to zero in the United States, and we still would not get to the point where you and I both want to get to.

Secretary CHU. I agree with you. I think given where we are today, that is why I want to invest a lot in developing clean coal methods. It is going to take awhile to grow a transmission line system, to grow the renewable energy that we need. In the meantime,

our baseload generation for this decade will be coal, gas, and nuclear. And so as we aggressively push the other issues, we have to—and, quite frankly, as I have said many times today, coal is going to be part of America's future in this century. There is no doubt about it.

Senator BUNNING. I hope that your boss and your administration remembers that in the policies that they push in the Department of Energy and in any energy bill that we are going to address, like the renewable portfolio bill that is coming before our Energy Committee very shortly. It excludes any kind of clean coal technology, or doesn't exclude it but doesn't emphasize it, and coal-to-liquids is completely left out. So I would hope that there would be some—I have gone over my time. I am sorry, Mr. Chairman. I will question later on.

Chairman CONRAD. I thank the Senator.

Senator Sanders.

Senator SANDERS. Thank you, Mr. Chairman.

Dr. Chu, welcome. First of all, let me begin by congratulating you and the President on your budget. For many years now, we have been talking about global warming, we have been talking about energy independence, but I think for the first time in history, you guys have walked the walk. You are beginning to put the tens of billions of dollars that we need into weatherization, energy efficiency, sustainable energy, so congratulations for taking a significant step forward.

In this panel and on this committee this morning as well as in many previous hearings, there is always a lot of discussion about coal and so-called clean coal. There is a lot of discussion about nuclear. There is not a whole lot of discussion about solar. Not a lot of discussion about solar. Solar shines in Kentucky and in Vermont occasionally and the Southwest of this country a whole lot. And in fact, I have heard people talking about the Southwestern part of this country being the Saudi Arabia of solar energy, if you would like.

And I have talked to people who know a whole lot about this who suggest that the technology is there now, today, that in a couple of years, we can be building numerous solar thermal plants which emit virtually no greenhouse gas emissions, stable long-term price. For the life of me, I just don't understand why we are not moving forward.

So my first question to you is, do you, A, agree that solar thermal has potential? I don't know if you have visited the Solar One, I think it is called, in Nevada. They are producing electricity for some 20,000 homes. Very quiet, there it goes. There are plants online right—not online, but on the drawing boards that can produce electricity for four or five hundred thousand households. So do you agree with the potential for solar thermal, and B, what are you going to do so that President Obama will be able to cut the ribbon for the first significant solar thermal plant in his first administration?

Secretary CHU. I agree that solar thermal and photovoltaic have great potential. If you look at how much sunlight hits the United States and how much sunlight—a very small fraction of our deserts could be generating at 20 percent efficiency all our electricity needs

if we could have a distribution and storage system that can handle that. So there is incredible potential. In fact, I did a quick calculation. We are talking about a few percent of the world's deserts that satisfies all the world's electricity needs. So ultimately, solar will be the answer, but the question is how do we get there.

I think solar thermal right now for utility generation makes more sense than photovoltaic. The last time I looked, it is about a factor of two less per installed kilowatt generation. There are some projects being discussed very actively. I think we are looking at loan guarantees on some of them. And I would dearly love to——

Senator SANDERS. I would like to continue this—I just yesterday, as a matter of fact, talked to a couple of private sector guys who are prepared to put substantial sums of money into these projects. My understanding is that you can construct these things in several years at not an outrageously high price. Do you have optimism that within the first 4 years of the first Obama administration that we are going to be cutting a ribbon for a major solar thermal plant?

Secretary CHU. Yes.

Senator SANDERS. Can we do it?

Secretary CHU. Actually, well, I know there is one in California being discussed very actively——

Senator SANDERS. There are several. There are a number on the drawing boards.

Secretary CHU. And I would hope so, yes.

Senator SANDERS. But here is the point. They are on the drawing boards. I have been talking to people for several years and I am just getting impatient. I mean, will you make it a high priority so that we are beginning to build these plants, which have, as I think you have indicated, so much potential?

Secretary CHU. Yes.

[Laughter.]

Secretary CHU. How is that?

Senator SANDERS. We need a "Yes," not a—a little bit too much wavering in that yes. I mean, do you think we will have a——

[Laughter.]

Secretary CHU. Yes.

Senator SANDERS. I want to see the President cut the ribbon. I want to be there. Do you think I am going to?

Secretary CHU. In the next 4 years——

Senator SANDERS. Within the next 4 years.

Secretary CHU [continuing]. A very high likelihood that we will——

Senator SANDERS. You think there is a high likelihood that we can do that. OK.

Secretary CHU. But again, the details of this, there are—you know, there are environmentalists who are resisting, as you may know——

Senator SANDERS. I know, as well, and I think a lot of the problem is more financing than, in fact, technological and engineering. How do you get the money to these guys? You indicated that in the budget, I think we have $6 billion for low-interest loans—in the stimulus package, which presumably can be used for this, is that correct?

Secretary CHU. Correct.

Senator SANDERS. Second question, the potential of photovoltaics. My understanding is that it is a question of scale. The more we produce, the more we use, the less expensive they become. Do you have any guess, if we expand photovoltaics and start getting them out, and I think the stimulus package will help us do that, when do you see photovoltaics becoming competitive with more conventional forms of energy?

Secretary CHU. You are right that the so-called learning curves, if you plot it on the Y-axis, cost per installed kilowatt hour, and the X-axis is the amount deployed, that as you deploy more, that naturally drives the cost down and virtually all technologies follow a Morozov curve with regard to that. But there are times when you can fall off that Morozov curve. The way you fall off of it is—because there is progressive improvements in driving the cost down, improvements in the technology that keep you on the Morozov curve. But you can fall off of it when you run out of improvements and you can fall off of it if you actually too aggressively push it because it takes time for those incremental improvements.

So this is one of the issues. Again, I am referring now to a Department of Energy report on when it would take, given the Morozov curve in investments in photovoltaic technology, when will it be competitive with fossil fuel. But the competition of fossil fuel is wholesale production——

Senator SANDERS. Right.

Secretary CHU [continuing]. And that is a pretty high bar. And so, quite frankly, I think, and this is where the universities and National Lab System can plan an incredible role, I would love to invent dramatically better technologies than just driving down the cost of photovoltaics.

Senator SANDERS. OK. Thanks very much.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman.

Dr. Chu, it is good to see you. I have great confidence in your abilities, and if you will just sift through all these difficult issues and give us your honest evaluation of what makes sense, then I think that can be a big help to us.

I would just say my philosophy is I am willing to support any technology that works. I think we need to be more focused on actually getting the technology identified and into the system and actually producing rather than sustaining it with subsidies forever and ever because those are so expensive. But I really believe in the goals that we have here. It will be good for our economy and I appreciate the abilities you bring to this issue.

With regard to the nuclear question that so many have asked about, I would just say I did notice in your written statement you didn't mention nuclear in any significant way, and I am glad your answers to the questions were more positive, because we were all a little uneasy. That is why you are getting a lot of questions. I know that is not the only answer, but it is a factor, I believe, in the answer to it.

With regard to the loan program, a number of us are critical of the Bush administration for not getting that loan program up. I

think there is $40-plus billion available. Can you tell us to date how many loans have been made in that program?

Secretary CHU. To date? Exactly zero, but as I said, beginning the first week since I assumed my responsibilities, we have been looking very hard at this and I hope in the coming weeks you will look upon the Department of Energy differently in how we can expeditiously assess these loans and get them out.

Senator SESSIONS. I just wanted you to say that "zero," because it is not your fault yet. It soon may be if they don't get made. But it is unfortunate. It does provide some opportunities for loans for nuclear power, does it not?

Secretary CHU. Yes.

Senator SESSIONS. And you are not adverse to allowing them to have the share that they are entitled to——

Secretary CHU. No.

Senator SESSIONS [continuing]. Under this program?

This nuclear waste fund, the ratepayers are paying about $750 million a year. That was about $26 billion has been paid into this fund, basically from ratepayers in their electric rates, and they were expecting and the utilities were expecting there to be a site that they could store this waste. So you recognize, do you not, that if we don't do the Yucca that you have decided not to do, if we don't do that, we have a very real obligation to come forward with a positive plan—maybe it is recycling, which I have favored and have offered legislation to that effect—but some sort of plan that would break the logjam here of how to handle the waste.

Secretary CHU. I absolutely agree with that. We have to come up with a viable plan that is going to be acceptable to our country, absolutely, and it has to be done in a timely manner.

Senator SESSIONS. With regard to the renewable energy proposals and the mandates that are out being discussed and have been offered before, to me, it only makes sense that if a utility, maybe they are approved by the Public Service Commission, and they invest billions of dollars to build a nuclear plant and it takes five, 6 years, 7 years to get the plant up and actually operating, and they are spending billions of dollars on that which would produce a plant that would for 60-plus years produce pollution-free, CO2-free electricity, that they ought to get some credit for that, particularly in areas like my area of the country where the wind is not available. It is too cloudy. Solar does not work. And we just don't have the options.

Can we figure out a way that in the portfolio standards that we give some credit for a company that is investing billions of dollars in a clean energy source?

Secretary CHU. I think you are raising very important points, and one of the things, in fact, as I understand it, the Energy Act of 2005 addressed is the very long approval process where you are investing these billions of dollars and not getting a return on investment for years. You have dug yourself a financial hole. And so one of the very first things that one has to do is to figure out how to streamline the process to make it much faster. Even a few years off means a whole lot for economic viability.

And so that is the strategy, the strategy of licensing. We have, in the past, every nuclear power plant was a one-off and there had

to be a separate detailed safety evaluation by the NRC. One of the reasons why France has been so successful in building up its nuclear potential is because they had very similar reactors. You know, the old joke is, when asked why France has nearly 80 percent nuclear power, we have 20 percent, and the answer was in France, we have hundreds of cheeses, one reactor. In the United States, you have one cheese, many reactors.

So we are trying to license a very limited set of new reactors. I mentioned the Westinghouse and the GE one as those. Once you license a generic reactor, then there is a much shorter time to license that particular site. And so that is one of the things we are working on. I think in the Energy Act, there was a—if the license time went over a certain amount——

Senator SESSIONS. You are analyzing that very clearly and I appreciate it. I was just saying that the renewable portfolio standards could cost companies in the whole Southeast region a lot of money because we don't have the options that other areas have. But they would have to meet that at great cost while they are still trying to invest billions in a nuclear power plant, which is odd to me. Thank you.

Chairman CONRAD. Thank you, Senator.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Secretary Chu, I want to ask first about the question of the higher cost of fuel that you would see associated at least with some versions of the cap and trade system. It hasten to the point now, given the speed at which this issue is moving along, I actually moved to adjust my tax reform proposal, it is called the Fair Flat Tax Act, just to start trying to deal with this question.

So let me ask it this way. The administration proposes to use the Make Work Pay credit to compensate people for the higher cost of fuel that comes about through cap and trade, and the more I look at this, I am concerned about how this would affect various Americans in different income brackets and I want to ask you a couple of examples about it.

The Make Work Pay credit has a refundable section that is designed to reach low-income taxpayers, but based on my reading, it wouldn't reach the very poor, the poorest among us who don't file a tax form and also are most vulnerable to higher fuel costs. So it looks, at least if you just look at the budget documents, the way cap and trade is set up now and tying it to the Make Work Pay credit, that the very poorest in our country, the people who can least afford it, are sort of left out. How would you deal with those people who don't file a tax return?

Secretary CHU. Well, I mean, in all honesty, I have not devoted a lot of my time up until now on that aspect of what you do with the revenues. I think this is something that the administration should be in deep discussions with Congress to be working out. And so you raise a very important point.

Senator WYDEN. But you haven't gotten into it yet?

Secretary CHU. I personally have not gotten into how you deal with the revenue stream that you want in order to relieve some of the strains and the consequences of a cap and trade bill.

Senator WYDEN. I don't want to be harsh, but I think the administration has to get into this issue. I mean, these are the very poorest among us at a time when a lot of them feel like they are getting hit with a wrecking ball. I have one of the highest unemployment rates in the country. I see my friend, Senator Stabenow from Michigan, same situation. If we are talking about a major environmental initiative, a cap and trade is being discussed in climate change, and people haven't thought through what this is going to mean for the poorest among us, we have to put some changes in place and get out this issue.

Secretary CHU. No, I was speaking about me. I am just a lowly scientist.

Senator WYDEN. Well, who is? You are the Secretary of Energy——

Secretary CHU. That is true.

Senator WYDEN [continuing]. And you are going to be one of the key players in this debate about climate change. I sure hope you all will get at it.

Let me ask one other kind of substantive question on this. The cost of oil has fallen from about $150 a barrel to about $40 a barrel in the last 9 months. I think we all know it goes up and it goes down. How would the administration adjust the value of the Make Work Pay credit in line with the rise and fall of fuel costs?

Secretary CHU. Again, at this point in my time, for me personally, I haven't given that much—these are things that other people in the administration, I am sure, have had a great deal of thinking about this, but——

Senator WYDEN. Who are those people?

Secretary CHU. Well, I mean, it would be the people more on the economic side of what it is. But I certainly—and you are right, I am part of the administration and I have to get into those things, as well. But again, my background is as a scientist, not as an economist, and——

Senator WYDEN. Could you get back to me with answers to those particular questions?

Secretary CHU. Yes.

Senator WYDEN. Because I don't think those are the only income groups. I have some questions—I am for the Make Work Pay credit. I mean, I think the President of the United States is trying to send the right message. But we have to think through the economic consequences here or a lot of people are going to get hurt. Can you have some answers to my questions, say, within 2 weeks?

Secretary CHU. I will certainly try, Senator.

Senator WYDEN. And if you would send those through the Chairman and the Ranking Minority Member so that all members of the committee could have it, that would be helpful.

Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator Enzi, please.

Senator ENZI. Thank you, Mr. Chairman.

Mr. Secretary, I am very impressed with your answers and your range of knowledge and all the things that you said here today, in particular your emphasis on energy research. I realize from your background that that would be an emphasis, but Wyoming is par-

ticularly interested in the research and have made some huge funding commitments to research. One of their commitments is based on abandoned mine land money.

There was a tax that was going to expire about 3 years ago and of that tax, half of it would go to resolve abandoned mine land problems in the East and half would be returned to the State where the coal was dug to take care of the abandoned mine land projects. Wyoming was one of the States that went ahead and resolved a lot of those projects even before the government released the money, which they didn't do for about 30 years. Since the coal tax was going to run out, we got together an interesting coalition of people and extended that tax, with the promise that that money would be coming back to Wyoming. The legislature has committed this money to energy research for our State.

Now, your budget calls for eliminating the return to the States that in good faith made that operation, and one of the things I am worried about is in the future, if we are putting together unique coalitions like that, can we trust the government? I was hoping that you might take a role in seeing that our research money continues. It is money that was stolen from Wyoming for 30 years before we were able to get a release on it, so it is a fairly big chunk of money now. But if it doesn't come through, we won't be able to continue the research that the State has already obligated to do through 2011. So I hope—my question is, will you help us play a role in that?

Secretary CHU. Well, I will certainly look into this and get back to you on that.

Senator ENZI. OK. I appreciate it and understand that that would be the best you would be able to do at the moment, but I will look forward to visiting with you some more about it.

I am a huge believer that incentives work better than penalties, although recognizing that sometimes penalties need to be in place because there are bad actors. One of the incentives that I hope we can do in energy is—for cleaning up energy is to put some provisions into Federal law so that companies can be assured that if they do research and find things that work and add it to their plants, that it can go into the rate base right away. I suspect that there are some other incentives that could be placed on that.

One of the biggest questions they have now is will we be able to get a return on the cost? It is my hope that you would help promote that sort of thing and that would be my question, that and maybe you might know some other ways that we can provide incentives that will get people on board with cleaning things up.

Secretary CHU. Well, Senator, I actually agree with you. I believe more in incentives than regulatory pushes. The rate base is determined by, as you know, the regulatory agencies. Historically, the regulatory commissions felt that there was a single criterion. They were advocates for the consumer. Now as we enter into this new era of the specter of some consequences of climate change we don't want to see happen, there is another issue on the plate, as well, and so I would like to see the regulatory agencies—these are local, within States and sections, and within States—begin to fold in these other concerns.

Senator ENZI. Except that we are about to make it a Federal issue and a Federal tax, because we are talking about cap and trade, which is a tax, and that tax will be passed on to the consumer. In the budget, I noticed that, yes, some of that is going to go to energy research, and I think that is tremendous and provides maybe an incentive. It is kind of a back-end sort of an incentive. But a portion of that is going to cover the increased taxes that people will have on energy consumption, which does give some recognition that it is the consumer that is going to pay the taxes.

I thought that the purpose of cap and trade was to have all of the money that was coming in from whatever was being taxed would go toward the solution of that tax. Does your Department have any role in how that is divided up?

Secretary CHU. I think the recognition that a significant part of the money goes to offset the economic consequences of the poorest parts of our population is important. But I also simultaneously believe that the money going into research and development so we can get much better solutions than we have today is actually essential. So it is really what is the proper balance.

Senator ENZI. My time has expired. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator Stabenow.

Senator STABENOW. Thank you very much, Mr. Chairman, and Secretary, welcome. I appreciate all of your efforts to date. I know you have come in with many different challenges to face, so we appreciate that and look forward to working with you as we implement the recovery package and move forward, obviously, on the energy bill and cap and trade and so on.

One of the things that I am very pleased about is that the energy bill invested in batteries, which is such critival technology to develop, but also the 30 percent manufacturing credit, the extension of the investment tax credit, the production tax credit, and the connections to a grant program for those not currently making a profit. I think these are all important steps in the right direction on financing and showing that there are jobs in the new green economy, which I think is critical in order for people to feel good about moving ahead on what we need to do as it relates to carbon.

My question goes to the broad issue of financing, because in the budget, the President has placed $15 billion per year for new clean technologies, which I commend, but it is tied to the cap and trade program and it is tied to a policy of 100 percent allocations or auctions, I should say, which I think it is unlikely, actually, to actually happen, and certainly will not happen until down the road.

Right now, we need financing. We have Section 136, which I was pleased to be the architect of, and we need to certainly get those dollars out as quickly as possible, loan guarantees and so on. But I wondered if you might speak to a willingness to work with us on a financing mechanism. We talked about it in the Energy Committee at your hearing. The Chairman of the Energy Committee is talking about an effort to put together a clean energy fund financing mechanism. It is so critical that we not wait if we are going to take advantage of the opportunities that we have right now, and frankly, opportunities that I believe are moving quickly away from us overseas and that we have to grab onto.

When we look at our competitors around the world and their capacities, like Korea, to have financing mechanisms that draw people there, or Germany with major manufacturing tax incentives and so on, which we are beginning to address, I think it is absolutely critical that within the confines of this budget we are focusing on clean energy financing not tied to something down the road but something that we can begin to do right now. I wondered if you might speak to that.

Secretary CHU. Well, Senator, I do agree with you that the nurturing of American industry into developing clean energies is very important. I personally have witnessed, as I began to get more and more into this energy problem, how when you look around, which country has the lead technologies, it is surprisingly fewer and fewer of them are in the United States and this is very troubling. I think we have to develop mechanisms to encourage the United States to regain the lead in many of these advanced technologies. I think over the last period of time, we invented many of them.

And so in terms of the long-term investment in the research, the development, the innovation, it is something that is very important and I will certainly hope to work with you and the rest of the members in Congress in making sure that that continues. We have incredible intellectual talent in this country and we need to adjust the conditions to really nurture that intellectual capacity and to the point where industry, the private sector is actually investing in these technologies, and I will be working with you on that.

Senator STABENOW. Thank you. As a followup: we certainly know the capital markets right now have done nothing but make the current situation worse. There is no question about that. We have a number of very important projects that have applied through Section 136, some on battery technology where literally we have a window of opportunity of months before those go overseas. And, in fact, I know of situations where dependent upon our financing, decisions will be made to bring proposed plants back from Korea or other countries. But we are in a very small window of time before those investment decisions will be made. So I am wondering if you can update us on Section 136 and how quickly we can see the loans being given.

Secretary CHU. I share your sense of urgency on this, and I do know of those issues. And as I said before, you know, since assuming these duties, I have taken this as my highest priority, is how do you actually streamline the process. And this is being done, has been done, and so hopefully in the next few weeks you will hear some very good news.

Senator STABENOW. Well, I appreciate that. I know it is your priority, and I would just support it and emphasize I think it is absolutely critical to achieving the broader goals of showing that turning to a new green economy actually creates jobs.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Stabenow, very much.

Senator Whitehouse is next, and then Senator Nelson.

Senator WHITEHOUSE. Thank you very much, Mr. Chairman. And welcome, Secretary Chu. The last time we met was February 4th when you were at the caucus, and I handed you a letter concerning increasing the contract ceilings under the DOE's Super Energy

Savings Performance Contract Program, which has hit a contract ceiling, but there is a lot of work ready to go on Federal buildings. It has been estimated that it is $2.2 billion worth of what everybody would call shovel-ready stuff.

In the past, for the technology-specific photovoltaic solar contract, the ceiling has been lifted. Is this something that you can lift? We have not had a response to that letter to find out where we——

Secretary CHU. I am sorry. Are you talking about the ESPCA, the Energy Savings——

Senator WHITEHOUSE. Yes.

Secretary CHU. OK. Actually, I looked into it, and I signed a waiver, I think 3 or 4 weeks ago, that said because of the—that there was a very good response to those, and we had gone over the previous limit. We looked into it. There is a 30—I believe there is a 30-day waiting period. If you did not get the information, I apologize. But I actually signed the waiver maybe 2 or 3 weeks ago on that.

Senator WHITEHOUSE. Wonderful. So we succeeded.

Secretary CHU. Yes.

Senator WHITEHOUSE. Thank you.

I was delighted to hear you mention over and over again your observation that so often this is U.S. technology. And the development of it into marketable products has moved overseas. I was in Spain at a solar array that is generating electricity right now, and the technology was developed in the United States. It was developed pursuant to a U.S. DOE grant. Because they had feed-in tariffs, that is where they developed, and that is where the technology solutions were put together to make it a marketable product. And now they are lined up to build the product in Arizona. So U.S. technology, U.S.-funded, and a U.S.-built project had to be essentially laundered through a foreign country in order to bring it to market here.

I think what that suggests to me among a lot of other examples is that your job at the Department of Energy is obviously to a certain degree a technological job, but it is also very much an economics job. If we can, as you said, adjust the conditions for technology development, we do not have any shortage of ideas or talent. We just have economic signals that discourage this.

The area that worries me the most is conservation, which, as you said, is the most effective bang for the buck on energy. However, it is very hard to find—to make it sexy for an investor the way a new technology might make somebody a million dollars, conservation, caulking, you know, it is not all that new tech. And the people most likely to be involved in this are the electric utilities for whom it is a real challenge to their business model, which is to sell kilowatt hours of electricity. And I am wondering what your thoughts are on how you adjust the conditions so that conservation becomes not only cost-effective for us as a Nation, but cost-effective and economically productive as an activity for individuals who participate in it, because we are way, way, way behind the curve. And I would like you to touch a little bit on what you feel about whether you might have something to do with the Federal Energy Regulatory Commission. We used to have utilities, and now they have been

busted up into distribution companies, transmission companies, generating companies. No reason we could not also have conservation companies, it would take some regulatory activity to force that.

So if you could talk a little bit about conservation, changing the economics, and the regulatory role in that, and your coordination with FERC on that.

Secretary CHU. Sure. OK, so let me start with efficiency and conservation. I think there are a number of mechanisms that should be piloted. A lot of times, if you consider the building of a commercial building, there is an architect; there is an structural engineer; there is the person who builds the building. It is rare that the design, the operation and maintenance of the building, the whole life cycle of the building is under one roof the way it would be, for example, in a government building or a university building, and it changes hands. Because of that, there are very split incentives. If you want to invest 5 or 10 percent more to make a much more efficient building, it does not really serve it. So we have to figure out a way in order to distribute the incentives.

One of them might be in the first 5 or 10 years of the operation of the building based on performance of that building, that if it exceeds a certain amount, a sharing of both—it could be a local slight decrease in the property taxes of the building. It could be—when you see a decrease in the operation of the—decreased utility, that you provide incentive to make sure the contractor, when they do the value engineering, when they are actually building the building, that the first thing that traditionally has dropped off the plate are the things that give you more energy efficiency. So there are things of that nature.

In residential homes, I would like to see the banks ask that the last year's gas and utility bills are—you know, a counterfeit-resistance copy of that is presented. Why is that relevant? Well, it is relevant because if the utility bills are $400 or $500 a month, that actually has a significant impact on one's ability to pay a mortgage, just as termites in the home would have a significant impact.

So you can have—this is the bill, and for this size house in this region of the U.S., which it all could be on record, a mixture of the utility bills plus what we know about the size of the homes from the property records, that there is a distribution—just like in a refrigerator, when you buy a refrigerator, here is the distribution of energy and here is an arrow where this house is. So it creates a more informed buyer and encourages the current homeowner to make investments in energy efficiency because it increases the resale value of that home.

So those cost the taxpayer very little—nothing, essentially, but these little tools can be used. And so a number of them—and I can go on about this because I have given a great——

Senator WHITEHOUSE. I am running into Senator Nelson's time at this point, so let me cut you off and just say I look forward to continuing to have discussions with you about your role as Secretary of Energy Economics.

Secretary CHU. OK.

Chairman CONRAD. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman. Good morning, Dr. Chu.

Last evening, Congressman Bart Gordon, the Chairman of the Science and Technology Committee in the House, released a GAO report that says that a carbon capture coal project called FutureGen, which was killed by the previous administration, was, in fact, done on a miscalculation, and this is chronicled this morning in the New York Times, and let me just read a couple of paragraphs here.

"The error led the Department of Energy to say mistakenly that the project, known as FutureGen, had nearly doubled in cost—an increase the Bush administration deemed too expensive. At the time, FutureGen was the leading effort to capture and sequester carbon dioxide, the main heat-trapping gas linked to global warming. If the project were resumed and proved successful, it could prove a model for curbing the carbon dioxide that coal adds to the atmosphere."

What do you know about this mistake that the GAO has come out with in the report? And who is responsible for it? And what are your future plans with FutureGen?

Secretary CHU. My understanding is the following: When the price was first put on that project, it was a price of this is what it would cost in—you know, whatever time it was—2004 or 2005 dollars, and it did not include the fact that, as you go forward in time over the construction time of the project, let us say it is 3 or 4 years, that you fold in inflation costs, the increase in cost of the commodities that would be put in the plant. So it was in dollars times zero, and the real cost of any project has to fold in those increases.

Senator NELSON. As a matter of fact, the New York Times says that—they said in canceling the project that it had increased from $950 million, almost doubling to $1.8 billion. But, in truth, the auditors in GAO said it had gone up 39 percent, to $1.3 billion.

Secretary CHU. Yes, and that is precisely this—the proper costing of any project has to include what you see as trends in the costs of the materials and during the time. And so that was part of it. Now——

Senator NELSON. Well, that is a pretty big mistake. Who made that mistake?

Secretary CHU. Well, I am not responsible for that mistake.

Senator NELSON. No, but do you have some ideas?

Secretary CHU. No, actually, I don't, quite frankly.

Senator NELSON. It is the previous administration, so you are going to just plead the Fifth, then. OK.

Secretary CHU. Well, I don't think——

[Laughter.]

Secretary CHU. Let me just say that on my watch, I hope we don't make a similar mistake. There has been, in addition to the 1.8, there have been estimates that it has gone higher.

Now, having said all this, I am beginning to look very closely at this project and I think there is a lot of merit in really testing the gassification, the capture and the sequestration all in one unit. The current price, as I understand it, is still very high, as I have said in previous comments. We have to—I think it does make a lot of sense to test this idea, but we also have to spend a lot of time and attention on post-combustion capture.

And so I am actually personally looking into how do you bring down the cost so we can go ahead. So at this time, that is—there are many things, as you have probably noticed, that haveten a lot of my attention and there are only 36 hours in a day and so I will do my best.

Senator NELSON. In your opinion, does this technology—is this promising to get a complete capture of carbon?

Secretary CHU. Actually, it is a technology that is certainly worth testing, in my opinion. The complete capture of carbon is a different story. There are price needs on what one can do, and so you have to look at cost-benefit analysis, as alluding to the Senator's comment about the Secretary of Energy and economics. Once you do a cost-benefit analysis, I think future technologies going forward will help us capture more and more of the carbon. But if we lay out a plan that says we have to capture 95 or 90 percent and makes it prohibitively high, that will begin to delay—that will delay the first experiments and deployment and I would rather see it getting started.

Senator NELSON. Well, good luck, because we do have a lot of coal——

Secretary CHU. Yes.

Senator NELSON. And if we can stop carbon going in the atmosphere, it is certainly to our advantage because of that energy source there.

I know you all talked earlier, and I have just got a little bit of time left. I just want to put my marker down that I have no objection to offshore drilling if it is done responsibly and if it is done where the oil companies already have leases. There are some close to 80 million acres under lease. I know that there are 33 million acres under lease in the Gulf of Mexico that have not been drilled. I am talking about 80 million acres that haven't been drilled. There are 33 million acres under lease in the Gulf of Mexico that haven't been drilled. And, of course, I have been the point on this, trying to protect the U.S. military's interest in the Eastern Gulf of Mexico, of which the operative policy in the Department of Defense is that you can't have oil rigs out there where we are testing and training and testing some of our most sophisticated weapons. So as you approach this, you and Secretary Salazar, I want you all to be mindful of the balance of issues.

And also, I don't think nuclear has been brought up here at this hearing. Clearly, after Three Mile Island, we now are a lot safer with nuclear and should be able to tap that source in a safe and responsible way to meet our energy needs in the future.

I know my time is up, but any comments, I would love them.

Secretary CHU. Nuclear is going to be part of our energy future and it has to be. And the issues you raise are very important ones and that is correct. There are a lot of oil leases out there that are not being used.

Senator NELSON. Thank you. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. Thank you, Senator Nelson.

A couple of quick things. One, you have been in the academic world and in that world you grade people on their performance. You get an A-plus. You couldn't have done better here today. I just wanted to say that.

Second, in terms of climate change, I think it is very important for the administration to understand what I am hearing. I reported yesterday some of what I have been hearing, and I know it discomforts some in the administration to hear that the budget as is, in my judgment, just as it has been written, probably can't pass here. Now, I say that because I have colleagues coming to me every day, saying to me, if this is in, don't count on my vote.

One of the things that a group of colleagues has come to me about is with respect to the auctions and a concern that there are insufficient resources to offset effects on consumers and companies that are very adversely affected. And I know we had—yesterday, the head of the Office of Management and Budget told us that he has grave concerns about using—to having some allocations.

I just say to you, in terms of getting something passed here, not an academic exercise but a real world practical politics exercise, in terms of getting something passed, there is going to have to be flexibility on how the funds are used. The notion that very adversely affected companies are not going to be given any help, I don't think—I am just making a—this is not my position, just my observation based on colleagues coming to me. And so it is very, very important that we have flexibility and that we work together to try to resolve things to get a result, because it would be an utterly empty exercise around here not to get the votes to actually pass things and pass things that will make a difference for our country.

On the point that Senator Nelson made with respect to the Gulf, and he has—quite properly, he is defending his State as he sees in the best interest to defend his State. Others of us have a somewhat different view. You know, the way leasing works in the oil industry is you go out and lease vast tracts with no intention ever of drilling on all of it. That isn't the way it works. First of all, you go out and lease vast tracts and then you do exploration to determine where are the best prospects. And parts of the Gulf have been very picked over. The Western Gulf has been very picked over. The Eastern Gulf has not.

And with respect to the military's restriction, they have made clear to us and the Group of 10, the Gang of 10 that became a Group of 20, and by the way, Secretary Salazar when he was a Senator was part of our group—the military has made very clear to us they are open to working with us and technology has changed and you can have a much reduced footprint than was previously the case and, therefore, much less impact on military operations.

So I think all of this has to be kept in mind. Again, anybody that suggests drilling offshore is the silver bullet answer, that is just not serious, and I think virtually everyone up here knows that. But it is part of the mix. It is part of the mix, and there are other things that will be much more significant contributors. You have made clear the list here. Conservation and energy efficiency has to be at the top of the list. Anybody that has studied this for 5 minutes knows that what you said here today is true. And so let us be aggressive about doing those things, and I am sure you will be.

With that, if there is any final comment that you wanted to make, we would be happy to hear it.

Secretary CHU. Well, I thank you for your comments and especially the last ones. One final comment. I forgot to say that I consider energy efficiency to be terribly sexy.

[Laughter.]

Chairman CONRAD. OK. Well, you know——

Secretary CHU. But it is all in the eye of the beholder.

Chairman CONRAD. Yes, sir.

[Laughter.]

Chairman CONRAD. Look, these things are so very important for our country's future. We are blessed to have somebody of your capability and your character in this position of responsibility. And again, this was almost—if we were putting on a seminar, how to present yourself before a committee of Congress, your performance here today would be a pretty good place to start.

Thank you very much. The committee stands in adjournment.

Secretary CHU. Thank you.

[Whereupon, at 12:22 p.m., the committee was adjourned.]

Department of Energy
Washington, DC 20585

May 1, 2009

The Honorable Kent Conrad
Chairman
Committee on the Budget
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

On March 24, 2009, we sent you the edited transcript of the March 11, 2009, testimony given by Steven Chu, Secretary, regarding "The President's FY 2010 Budget for the Department of Energy."

Enclosed are six inserts requested by Senators Crapo, Warner, Graham and Enzi for the hearing record.

If we can be of further assistance, please have your staff contact our Congressional Hearing Coordinator, Lillian Owen, at (202) 586-2031.

Sincerely,

Betty A. Nolan
Senior Advisor
Congressional and Intergovernmental Affairs

Enclosures

cc: The Honorable Judd Gregg
Ranking Member

1 help to be a part of that solution.

2 Secretary Chu. Right.

3 Senator Crapo. And although I am very discouraged in

4 the decision that we have seen, I think we need to get very

5 aggressive at finding a path forward.

6 I have got a couple of other questions. I have got

7 about a minute left. One question I had is as we were doing

8 the--pursuing the stimulus package, one of the provisions

9 that was in it was a manufacturing tax credit, which again

10 talked about a lot of different forms of energy but it did

11 not specifically mention nuclear energy. As we revised the

12 bill on the floor of the Senate, we were able to change the

13 language there, not to mention nuclear specifically but to

14 give the authority to the Department of Energy to include

15 nuclear power in that manufacturing tax credit. I just

16 wanted to make sure you were aware of that and also to

17 receive your assurances that nuclear power will be able to

18 receive that manufacturing tax credit as we move forward.

19 Secretary Chu. I am not actually aware of the exact

20 details, but I will certainly look into it, and if it is

21 allowed, they will certainly be eligible.

22 Senator Crapo. All right. Well, thank you very much.

23 One last question. In President Obama's fiscal year

24 2010 budget request, he assumes 100 percent auctionable

25 allowances under a cap and trade legislation proposal.

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The manufacturing tax credit contained in Section 1302 of the American Recovery and Reinvestment Act of 2009 establishes a new 30 percent manufacturing project tax credit for investment in qualified property used in a qualified advanced energy manufacturing project. The Act defines a qualified advanced energy manufacturing project as a project that re-equips, expands, or establishes a manufacturing facility for the production of many different forms of energy. The seventh form of energy listed is "Other advanced energy property designed to reduce greenhouse gas emissions as may be determined by the Secretary" (of the Treasury). Credits are available only for qualified advanced energy manufacturing projects certified by the Secretary of the Treasury, in consultation with the Secretary of Energy.

While the Act does not specifically mention nuclear energy, a project that re-equips, expands, or establishes a manufacturing facility for parts or components for the production of nuclear energy could qualify under the seventh form of energy in the list, given a positive determination by the Secretary of the Treasury. The Act stipulates that the Secretary of the Treasury establish a certification program no later than 180 days after the Act's enactment date. More details will be available as we approach that date.

1 Twenty percent or $150 billion over ten years is directed to
2 clean energy technologies, including biofuels, renewable
3 energy, and so forth. Can you expand a little bit on what
4 clean energy technologies will receive funding from this
5 proposal and whether nuclear energy will be included there?
6 Secretary Chu. Again, I am not sure of the exact
7 statutes, but let me tell you what I understand it is going
8 to be. Biofuels is an example. Clean energy biofuels is
9 what I call fourth generation biofuels, where you put in far
10 less fossil fuel inputs into the lifecycle generation costs.
11 Advanced batteries--we do not have batteries that can last
12 15 years of deep discharges, that we need probably a factor
13 of two or three higher energy densities before I could see a
14 massive deployment of plug-in hybrids, and then even a
15 better battery for all-electric vehicles. Those are
16 examples of clean energy technologies.
17 Senator Crapo. Would nuclear be included, in your
18 opinion?
19 Secretary Chu. I would have to look again at the
20 statute, quite frankly. Nuclear is--we have still a nuclear
21 waste issue we have to overcome and we have--but, you know,
22 if you look at the palette of our basic electricity now, it
23 is gas, it is coal, it is nuclear.
24 Senator Crapo. Well, thank you. I see my time has run
25 out.

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The President's budget refers broadly to "clean energy technologies" that may receive funding from cap and trade revenues. When referring to "clean energy technologies," the budget does not specifically mention nuclear energy. However, this does not necessarily exclude nuclear energy. Any eventual cap and trade system will most likely be set by legislation, which could determine what constitutes "clean energy technologies" and the subsequent distribution of revenues.

1 forward. And so we are hoping to announce within weeks the
2 first tranche of these loans.
3 We are also looking very much to your question about
4 how do you do this effectively, that you prevent fraud,
5 abuse, inefficiency. And so we are working with the
6 internal DOE IG, also with the administration IG, not to--
7 you know, they viewed themselves perhaps in the past as an
8 audit function to look into things where there might be a
9 suspicion of waste or abuse, but to actually anticipate what
10 might go wrong and start to plan as we get these things out
11 and how to monitor. So now they are becoming an integral
12 part of the planning process. As we release the money, we
13 will be releasing it in stages and will be looking very
14 closely, because whenever there is a new flood of money,
15 there is always a potential for it not being spent in the
16 wisest way possible.
17 So, again, this is a daily thing. I realized very
18 quickly--in fact, in my first week--within starting that I
19 needed someone who is very, very good, who could help the
20 Department of Energy respond in a way, because we cannot
21 fail on this.
22 Senator Warner. I just simply would add I commend you
23 for doing this, but I do not think some of your other
24 colleagues who have got equal challenge, particularly with
25 the Recovery Act funds, have put in place this same kind of

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The American Recovery and Reinvestment Act is an unprecedented effort to jumpstart our economy and put a down payment on addressing long-neglected challenges so our country can thrive in the 21st century. With much at stake, the Act provides for transparency and accountability by supporting measures to root out waste, inefficiency, and unnecessary spending. A coordinating Recovery Board has been established to develop the protocols to oversee government-wide spending, project reporting, and auditing. A website, Recovery.gov, will be the main vehicle to monitor progress on the Recovery Act funding. The Department of Energy (DOE) is committed to managing these funds effectively, and to maintain transparency will report directly to Recovery.gov to provide up-to-date data on the expenditure of funds. Recovery.gov features projections for how, when, and where the funds will be spent -- which states and sectors of the economy are due to receive what proportion of the funds and as money starts to flow, far more data will become available. The site will include information about Federal grant awards and contracts as well as formula grant allocations. Federal agencies will provide data on how they are using the money, and eventually, prime recipients of Recovery Act funding will provide information on how they are using their funds to implement projects. Some of the specific protocols in place are daily Recovery Act meetings, program fraud/risk training, pre-spend audits, and the requirement for risk management, phase-gate spending, and implementation plans.

1 Secretary Chu. Pardon? How did we arrive at what?

2 Senator Graham. The $646 billion in the budget set-

3 aside as a revenue stream from the cap-and-trade system.

4 Secretary Chu. The details of that I do not know.

5 Senator Graham. Okay. A hundred percent auction of

6 the credits.

7 Secretary Chu. Right.

8 Senator Graham. My concern--

9 Secretary Chu. Oh, sorry. I misunderstood your

10 question.

11 Senator Graham. I am sorry.

12 Secretary Chu. The money was, yes, going to come from

13 the credits. The exact amount or the estimate, I did not

14 know.

15 Senator Graham. Well, somebody has to assume that a

16 credit will trade at a certain amount to generate $646

17 billion. I would like to know the formula they used. If

18 you could get that to me, I would appreciate it.

19 [The information follows:]

20 / COMMITTEE INSERT

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Tables S-2 and S-6 (See Attachment) of the budget show the estimated year-by-year climate revenues dedicated to Making Work Pay and an investment in clean energy technologies, totaling about $79 billion in the first year. These estimates are placeholders until legislation is more fully developed, but they are conservative projections of the amount of revenue likely to be available. We developed these estimates by considering various analyses of climate bills proposed in the 110th Congress and updates to underlying assumptions in these models. As the details of the cap and trade legislation take shape, we will work to further update the models and revenue projections.

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SUMMARY TABLES

Table S–1. Budget Totals

(In billions of dollars and as a percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010-2014	Totals 2010-2019
Budget Totals in Billions of Dollars:														
Receipts	2,524	2,186	2,381	2,713	3,081	3,323	3,500	3,675	3,856	4,042	4,234	4,446	14,997	35,250
Outlays	2,983	3,938	3,552	3,625	3,662	3,856	4,069	4,258	4,493	4,678	4,868	5,158	18,764	42,219
Deficit	459	1,752	1,171	912	581	533	570	583	637	636	634	712	3,767	6,969
Debt held by the public	5,803	8,364	9,509	10,436	10,985	11,505	12,070	12,659	13,297	13,932	14,557	15,370		
Debt net of financial assets	5,297	6,943	8,072	8,960	9,541	10,073	10,642	11,224	11,860	12,495	13,129	13,840		
Gross domestic product (GDP)	14,222	14,240	14,729	15,500	16,470	17,498	18,386	19,205	20,060	20,952	21,884	22,858		
Budget Totals as a Percent of GDP:														
Receipts	17.7%	15.4%	16.2%	17.5%	18.7%	19.0%	19.0%	19.1%	19.2%	19.3%	19.3%	19.5%	18.1%	18.7%
Outlays	21.0%	27.7%	24.1%	23.4%	22.2%	22.0%	22.1%	22.2%	22.4%	22.3%	22.2%	22.6%	22.8%	22.6%
Deficit	3.2%	12.3%	8.0%	5.9%	3.5%	3.0%	3.1%	3.0%	3.2%	3.0%	2.9%	3.1%	4.7%	3.9%
Debt held by the public	40.8%	58.7%	64.6%	67.3%	66.7%	65.8%	65.6%	65.9%	66.3%	66.5%	66.5%	67.2%		
Debt net of financial assets	37.2%	48.8%	54.8%	57.8%	57.9%	57.6%	57.9%	58.4%	59.1%	59.6%	60.0%	60.5%		

Table S–2. Effect of Budget Proposals on Projected Deficits

(Deficit increases (+) or decreases (–) in billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010–2014	Totals 2010–2019
Projected deficits in the baseline projection of current policy[1]	**1,509.1**	**1,178.0**	**1,033.1**	**757.5**	**734.0**	**791.0**	**811.0**	**877.6**	**892.6**	**906.3**	**1,002.1**	**4,493.6**	**8,983.2**
Percent of GDP	10.6%	8.0%	6.7%	4.6%	4.2%	4.3%	4.2%	4.4%	4.3%	4.1%	4.4%	5.6%	4.9%
Reserve funds:													
Health reform:													
Health savings[2]	.....	*–1.8*	*–5.1*	*–18.0*	*–24.5*	*–34.3*	*–40.0*	*–47.1*	*–49.5*	*–44.8*	*–50.8*	*–83.7*	*–316.0*
Limit the rate at which itemized reductions reduce tax liability to 28 percent[2]	.....	.....	*–11.1*	*–30.8*	*–33.5*	*–35.5*	*–37.3*	*–39.3*	*–41.4*	*–43.4*	*–45.6*	*–110.8*	*–317.8*
Net total with additional savings and cost of health care benefits	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....
Climate revenues:[3]													
Dedicated to climate policy (clean energy technologies)	.....	.....	.....	–15.0	–15.0	–15.0	–15.0	–15.0	–15.0	–15.0	–15.0	–45.0	–120.0
Dedicated to Making Work Pay	.....	.....	.....	–63.7	–64.1	–64.7	–65.3	–66.0	–66.7	–67.3	–68.0	–192.5	–525.7
Placeholder for potential additional financial stabilization efforts	250.0	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....
Tax cuts for families and businesses[4]	28.5	49.0	19.3	90.3	96.3	102.3	108.3	113.2	116.9	120.4	124.2	357.3	940.2
Other revenue changes and loophole closers	–0 0	–1.0	–16.6	–28.0	–37.1	–42.9	–43.7	–44.5	–45.3	–46.3	–48.0	–125.7	–353.5
Proposed changes in mandatory programs and user fees	0.2	–5.0	5.1	0.7	–2.1	–2.5	1.4	4.7	7.1	9.9	11.3	–3.6	30.7
Proposed changes in appropriated ("discretionary") programs:													
Cost of overseas contingency operations	–31.2	–60.3	–118.6	–138.9	–149.7	–156.9	–163.1	–168.1	–173.1	–178.3	–183.5	–624.3	–1,490.4
Department of Defense (051) excluding overseas contingency operations	.....	5.7	6.1	3.7	1.7	1.5	1.8	0.8	0.7	0.7	0.6	18.8	23.4
Other appropriated programs	3.8	19.8	16.2	29.2	39.5	45.7	52.4	54.8	55.8	56.7	58 7	150.4	428.7
Subtotal, appropriated programs	–27.4	–34.8	–96 2	–106.0	–108 5	–109.6	–108.9	–112.5	–116.6	–120.9	–124 2	–455.2	–1,038 3
Subtotal, policy proposals	**251.2**	**8.2**	**–88.4**	**–121.6**	**–130.5**	**–132.4**	**–123.2**	**–120.1**	**–119.7**	**–119.3**	**–119.6**	**–464.7**	**–1,066.5**
Upper-income tax provisions dedicated to deficit reduction	**0.2**	**–1.1**	**–28.5**	**–49.0**	**–58.2**	**–67.3**	**–74.6**	**–80.6**	**–86.6**	**–92.3**	**–98.6**	**–204.0**	**–636.7**
Debt service	–8.4	–13.7	–4.4	–5.5	–12.8	–21.6	–30.6	–40.0	–49.9	–60.7	–71.9	–57.9	–311.0
Total reduction in projected deficits	**243.0**	**–6.5**	**–121.3**	**–176.2**	**–201.4**	**–221.2**	**–228.3**	**–240.7**	**–256.2**	**–272.3**	**–290.1**	**–726.6**	**–2,014.3**
Resulting deficits in 2010 Budget	**1,752.1**	**1,171.4**	**911.9**	**581.3**	**532.6**	**569.7**	**582.6**	**636.9**	**636.4**	**634.0**	**712.0**	**3,767.0**	**6,968.9**
Percent of GDP	12.3%	8.0%	5.9%	3.5%	3.0%	3.1%	3.0%	3.2%	3.0%	2.9%	3.1%	4 7%	3.9%

Table S–2. Effect of Budget Proposals on Projected Deficits—Continued

(Deficit increases (+) or decreases (–) in billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010–2014	Totals 2010–2019
Memorandum, proposed changes in appropriated ("discretionary") budget authority:													
Funding for overseas contingency operations	–50.3	–64.6	–148.3	–152.6	–157.2	–161.9	–166.7	–171.6	–176.6	–181.8	–187.1	–684.6	–1,568.4
Department of Defense (051) excluding overseas contingency operations	.....	10.3	6.9	3.1	.....	.....	.....	.....	.....	.....	.....	20.3	20.3
Other appropriated programs	7.1	31.3	29.5	47.5	49.7	53.9	53.3	54.2	53.6	53.6	55.6	212.0	482.2
Total, appropriated funding (budget authority)	–43.2	–23.0	–111.9	–102.0	–107.4	–107.9	–113.3	–117.4	–123.0	–128.2	–131.6	–452.3	–1,065.9

[1] See Tables S–3 and S–5 for information on the baseline projection of current policy.

[2] Non-additive.

[3] Shown here are those proceeds from auctioning emission allowances that are reserved for clean energy technology initiatives and to compensate families through the Making Work Pay tax cut. These proceeds are included in the grand totals as receipts, though they could alternatively be considered offsets to outlays. All additional net proceeds will be used to further compensate the public.

[4] Includes refundable tax credits.

Table S-3. Baseline Projection of Current Policy by Category[1]
(In billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010-2014	Totals 2010-2019
Outlays:														
Appropriated ("discretionary") programs:														
Department of Defense (051) including net of overseas contingency operations	599	697	728	727	739	757	773	792	811	831	851	872	3,723	7,891
Other appropriated programs	526	629	678	656	624	621	622	630	642	656	671	686	3,169	6,459
Subtotal, appropriated programs	1,125	1,307	1,400	1,383	1,363	1,378	1,395	1,422	1,453	1,487	1,522	1,558	6,892	14,294
Mandatory programs:														
Social Security	612	662	695	731	769	790	839	881	948	1,005	1,073	1,141	3,784	8,834
Medicare	366	425	455	498	561	556	595	651	724	756	781	872	2,813	6,797
Medicaid	201	239	290	274	289	299	322	347	375	404	435	468	1,465	3,482
Troubled Asset Relief Program (TARP)	...	247	...	...	...	...	...	...	...	...	...	...	...	...
Other mandatory programs	412	453	535	540	437	466	479	479	496	489	508	527	2,477	4,994
Subtotal, mandatory programs	1,591	2,026	2,014	2,053	1,957	2,091	2,244	2,359	2,541	2,658	2,796	3,018	10,549	23,741
Net interest	253	148	178	267	383	447	495	539	570	614	653	694	1,790	4,884
Disaster aid[2]	...	4	11	16	18	20	23	25	26	27	28	29	88	226
Total outlays	2,983	3,724	3,604	3,718	3,722	3,936	4,157	4,344	4,590	4,795	4,998	5,300	19,149	43,196
Receipts:														
Individual income taxes	1,145	972	1,041	1,218	1,378	1,493	1,585	1,690	1,789	1,888	1,992	2,109	6,715	16,332
Corporation income taxes	304	189	245	282	246	347	394	423	447	461	486	511	1,607	3,990
Social insurance and retirement receipts:														
Social Security payroll taxes	648	654	687	719	756	803	842	879	925	962	1,004	1,048	3,803	8,520
Medicare payroll taxes	154	161	196	210	222	235	247	258	272	283	295	308	1,110	2,525
Unemployment insurance	49	54	52	58	65	67	66	61	57	62	58	62	267	607
Other retirement	9	9	9	8	9	9	9	9	9	9	9	9	42	90
Excise taxes	67	72	78	83	87	88	90	91	92	92	94	95	427	893
Estate and gift taxes	23	26	29	33	25	27	27	29	31	33	36	38	121	288
Customs duties	28	24	24	29	33	37	40	43	46	47	49	52	164	399
Deposits of earnings, Federal Reserve System	34	26	27	29	36	39	42	43	45	47	48	50	168	403
Other miscellaneous receipts	17	16	16	16	17	17	17	17	18	18	18	18	84	173
Total receipts	2,524	2,215	2,429	2,685	2,975	3,369	3,566	3,543	3,732	3,903	4,091	4,294	14,426	34,213
Deficit	459	1,509	1,176	1,033	747	794	591	801	858	893	906	1,005	4,724	8,983
On-budget deficit	642	1,647	1,313	1,187	911	988	991	1,009	1,049	1,087	1,094	1,189	5,350	10,891
Off-budget surplus (+)	-183	-138	-135	-154	-174	-194	-200	-198	-192	-194	-188	-175	-627	-1,918

Table S-3. Baseline Projection of Current Policy by Category[1]—Continued
(In billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010-2014	Totals 2010-2019
Memorandum, funding (budget authority) for appropriated programs:														
Department of Defense (051) including funding for overseas contingency operations	664	712	718	732	750	768	786	805	825	845	865	887	3,756	7,983
Other appropriated programs	554	626	658	579	592	606	620	634	649	664	680	696	2,965	6,325
Total, appropriated funding	1,218	1,338	1,376	1,312	1,342	1,374	1,406	1,440	1,474	1,509	1,545	1,583	6,721	14,271

[1] See Table S-5 for information on adjustments to the Budget Enforcement Act (BEA) baseline.
[2] These amounts represent the statistical probability of a major disaster requiring federal assistance for relief and reconstruction. Such assistance might be provided in the form of discretionary or mandatory outlays or tax relief. These amounts are included as outlays for convenience.

Table S-4. Proposed Budget by Category

(In billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010-2014	Totals 2010-2019
Outlays:														
Appropriated ("discretionary") programs:														
Department of Defense (051) including cost of overseas contingency operations	593	666	673	614	604	609	618	631	644	659	674	689	3,138	6,414
Other appropriated programs	568	613	686	673	650	651	668	683	697	711	727	743	3,349	6,811
Subtotal, appropriated programs	1,160	1,279	1,365	1,286	1,257	1,269	1,286	1,313	1,343	1,370	1,401	1,434	6,487	13,225
Mandatory programs:														
Social Security	512	662	695	719	747	787	825	867	944	1,005	1,070	1,139	3,784	8,871
Medicare	386	425	453	498	530	555	602	650	723	756	788	872	2,631	6,391
Medicaid	201	220	250	274	280	292	322	347	374	403	435	468	1,464	3,452
Troubled Asset Relief Program (TARP)	...	547	...	...	...	...	...	...	...	...	...	...	...	...
Placeholder for potential additional financial stabilization efforts	...	150		...	...	...	...	...	...	...	...	...	...	...
Other mandatory programs	411	473	371	549	482	491	567	527	545	552	562	584	2,620	5,400
Subtotal, mandatory programs	1,510	2,516	2,009	2,040	2,069	2,132	2,267	2,412	2,587	2,717	2,848	3,073	10,471	24,113
Net interest	253	129	164	245	316	434	474	509	539	564	590	622	1,732	4,255
Disaster costs[1]	...	4	11	16	18	20	23	25	26	27	29	30	88	226
Total outlays	2,983	3,938	3,552	3,628	3,662	3,856	4,009	4,258	4,493	4,678	4,866	5,158	18,764	42,219
Receipts:														
Individual income taxes	1,146	938	1,061	1,249	1,383	1,516	1,635	1,719	1,817	1,923	2,033	2,152	6,837	16,499
Corporation income taxes	304	165	222	302	369	414	423	455	474	494	549	544	1,730	4,215
Social insurance and retirement receipts:														
Social Security payroll taxes	638	654	682	718	756	804	843	879	926	963	1,005	1,040	3,804	8,627
Medicare payroll taxes	194	191	196	210	222	235	247	258	272	283	295	308	1,114	2,527
Unemployment insurance	40	44	53	58	65	67	68	69	57	62	67	62	309	606
Other retirement	9	9	9	9	9	9	9	9	9	9	9	9	43	86
Excise taxes	67	71	77	75	79	79	80	81	82	83	83	84	390	804
Estate and gift taxes	20	26	20	23	25	27	27	29	31	33	36	38	121	288
Customs duties	28	24	23	28	33	37	40	43	46	47	49	50	163	397
Deposits of earnings, Federal Reserve System	34	28	22	29	36	39	42	43	45	47	48	50	168	402
Climate revenues	...	...	...	...	39	79	80	80	81	82	82	83	237	646
Other miscellaneous receipts	17	16	16	16	17	17	18	17	17	17	18	18	84	173
Total receipts	2,524	2,166	2,381	2,715	3,083	3,523	3,640	3,675	3,896	4,042	4,234	4,446	14,997	35,260
Deficit	459	1,772	1,171	912	581	333	370	583	597	636	634	712	3,767	6,959

Table S-4. Proposed Budget by Category—Continued

(In billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010-2014	Totals 2010-2019
On-budget deficit	642	1,190	1,312	1,071	762	714	777	799	948	842	831	903	4,658	8,865
Off-budget surplus (–)	–183	–138	–140	–161	–180	–202	–208	–206	–211	–203	–197	–187	–890	–1,906
Memorandum, funding (budget authority) for appropriated programs														
Department of Defense (051) including funding for overseas contingency operations	666	682	664	592	601	611	625	639	653	668	684	699	3,092	6,435
Other appropriated programs	554	613	639	599	646	656	674	686	703	718	734	752	3,276	6,773
Total, appropriated funding	1,219	1,295	1,303	1,190	1,248	1,267	1,299	1,325	1,357	1,386	1,417	1,451	6,368	13,208

[1] These amounts represent the statistical probability of a major disaster requiring federal assistance for relief and reconstruction. Such assistance might be provided in the form of discretionary or mandatory outlays or tax relief. These amounts are included as outlays for convenience.

Table S-5. Bridge from Budget Enforcement Act Baseline to Baseline Projection of Current Policy

(In billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010-2014	Totals 2010-2019
BEA baseline deficit/surplus (+)	**-458.6**	**-1,011.7**	**-550.7**	**-459.2**	**-194.5**	**-104.1**	**-53.7**	**-53.1**	**-71.3**	**-90.1**	**-53.4**	**-5.7**	**-1,488.9**	**-1,614.4**
Adjustments to reflect current policies:														
Extra inflation in the 2009 parameters of the AMT as enacted in the American Recovery and Reinvestment Act	...	...	14.7	71.6	94.9	39.2	45.4	54.5	63.1	72.6	83.9	96.3	265.6	575.9
Continue the 2001 and 2003 tax cuts[1]	...	0.2	6.2	154.9	234.1	244.2	254.4	315.2	330.0	344.7	360.5	377.8	993.1	2,621.2
Account for additional expected Medicare physician payments	...	...	12.8	24.4	29.6	37.2	42.3	43.3	41.1	34.5	30.6	32.9	147.1	329.6
Continue Transitional Medical Assistance and Qualified Individuals programs	...	*	0.9	1.3	1.5	1.5	1.6	1.7	1.8	2.0	2.2	2.3	6.9	16.9
Correct baseline growth rates for pay and social insurance administrative expenses	...	...	-2.1	-2.4	-2.4	-2.5	-2.6	-2.9	-3.2	-3.5	-3.9	-4.3	-12.0	-29.8
Subtotal	...	0.2	32.6	249.9	356.5	339.8	361.8	411.6	432.8	450.3	473.5	505.0	1,399.7	3,513.8
Adjustments to reflect legislation this session:														
American Recovery and Reinvestment Act	...	202.3	353.3	133.8	38.7	30.0	27.7	11.4	-0.5	-1.7	-1.1	-1.1	582.5	599.5
2009 full-year appropriations	...	13.1	10.4	24.5	23.9	24.6	25.3	26.9	26.5	27.1	27.7	28.4	108.7	244.2
Subtotal	...	215.5	363.7	158.4	62.5	54.6	52.9	37.3	26.0	25.4	26.6	27.3	692.2	834.7
Adjustments to reflect costs of overseas contingency operations and disasters:														
Remove portion of overseas contingency operations funding tax enacted for 2009	...	-40.6	-91.8	-64.7	-66.8	-68.6	-70.0	-71.2	-72.5	-73.8	-75.1	-76.5	-330.8	-700.0
Insert future overseas contingency operations funding tax enacted for 2010	...	126.1	177.4	189.6	196.8	202.6	207.8	212.6	217.5	222.6	227.7	232.9	974.3	2,687.6
Remove part-year international funding tax enacted for 2009	...	-2.2	-3.1	-3.8	-4.0	-4.1	-4.3	-4.4	-4.5	-4.6	-4.7	-4.8	-19.4	-42.4
Insert international emergency funding tax enacted for 2010	...	4.7	7.1	8.5	8.7	9.0	9.4	9.6	9.8	10.0	10.2	10.4	42.4	93.6
Remove non-recurring emergency funding	...	-2.5	-7.7	-12.7	-16.2	-17.4	-17.8	-18.2	-18.6	-19.0	-19.4	-19.9	-71.8	-167.3
Insert statistical probability of future major disaster costs[2]	...	2.6	10.9	15.9	18.3	20.5	22.6	24.8	26.3	27.5	28.8	30.1	88.2	235.7
Subtotal	...	81.6	192.7	132.6	136.7	142.2	147.7	153.2	158.0	162.6	167.4	172.3	682.8	1,106.3
Adjustment to Pell Shares, for comparability:[3]														
Remove Pell Grants from appropriated category	-14.7	-18.8	-23.5	-19.5	-17.8	-18.1	-18.4	-18.7	-19.1	-19.4	-19.8	-20.1	-97.4	-194.5
Add Pell Grants to mandatory category	14.7	18.8	23.5	19.5	17.8	18.1	18.4	18.7	19.1	19.4	19.8	20.1	97.4	194.5
Subtotal	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Total program adjustments	...	296.7	821.6	538.9	496.8	536.6	582.5	602.1	616.8	638.3	667.5	704.6	2,676.7	5,665.0
Debt service on adjustments	...	0.6	6.3	34.1	67.5	96.4	124.8	156.5	189.5	225.3	262.2	303.2	329.0	1,466.9
Total adjustments	...	297.3	827.2	574.9	564.2	633.0	707.3	757.6	806.3	862.5	929.7	1,007.8	3,004.7	7,132.8
Baseline projection of current policy deficit	**-458.6**	**-1,309.1**	**-1,178.0**	**-1,033.1**	**-757.5**	**-734.0**	**-761.0**	**-811.0**	**-877.6**	**-952.6**	**-986.2**	**-1,015.1**	**-4,493.6**	**-8,746.8**

* $50 million or less.
[1]In continuing the 2001 and 2003 tax cuts, the estate tax is maintained at its 2009 parameters.
[2]These amounts represent the statistical probability of a major disaster requiring federal assistance for relief and rental outlays.
[3]The amount of the reclassification equals the existing and projected amounts of Pell as increased on a one-time basis by the Recovery Act.

Table S-6. Mandatory and Receipt Proposals

(Deficit increases (+) or decreases (-) in billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010-2014	Totals 2010-2019
Tax Provisions:[1]													
Tax cuts for families and individuals:													
Provide Making Work Pay Tax Credit[2]	...	...	21,017	57,682	64,119	64,661	65,394	66,001	66,677	67,307	67,979	203,479	536,738
Expand Earned Income Tax Credit[2]	...	...	19	4,013	3,961	3,961	4,008	4,090	4,176	4,265	4,354	11,954	32,856
Expand refundability of the Child Tax Credit[2]	...	...	...	8,714	8,616	8,618	8,703	8,796	8,902	9,020	9,119	25,898	70,489
Expand saver's credit and automate enrollment in IRAs and 401(k)s[2]	...	...	227	3,018	4,707	5,906	6,969	7,722	8,271	8,916	9,406	13,908	55,232
Provide American Opportunity Tax Credit[2]	...	...	802	6,779	7,487	8,144	9,337	10,076	10,212	10,546	11,295	22,213	74,659
Total, tax cuts for families and individuals	...	...	19,225	80,197	88,890	91,291	94,411	96,685	98,422	100,157	102,153	278,613	770,116
Tax cuts for businesses:													
Eliminate capital gains taxation on small businesses	...	...	...	...	...	297	734	1,025	1,245	1,920	2,078	297	7,173
Make research and experimentation tax credit permanent	...	3,111	5,466	6,162	6,785	7,384	7,960	8,530	9,103	9,680	10,281	26,908	74,462
Expand net operating loss carryback	25,840	20,700	-10,700	-10,900	-7,900	-5,600	-3,900	-2,700	-1,800	-1,200	-800	1,300	-2,300
Modify Federal American Administration licensing[2]	...	...	7,225	7,599	7,860	8,209	8,519	8,869	9,180	9,537	9,873	31,054	77,082
Total, tax cuts for businesses	27,800	38,811	2,011	3,541	6,985	10,341	13,313	15,725	17,838	19,676	21,330	61,559	149,417
Continue remaining expiring provisions through calendar year 2010[2]	668	19,183	5,048	607	578	622	786	883	612	694	648	17,079	30,034
Other revenue changes and loophole closure:													
Reinstate Superfund Taxes	...	...	-1,213	-1,667	-1,863	-1,896	-1,970	-2,049	-2,143	-2,243	-2,350	-6,579	-17,205
Tax earned interest as ordinary income	...	...	-2,742	-4,347	-4,496	-3,484	-2,003	-2,304	-1,725	-1,251	-1,060	-14,751	-23,894
Codify "Economic Substance Doctrine"	-23	-72	-145	-240	-346	-439	-562	-656	-743	-834	-920	-1,234	-4,949
Repeal LIFO	...	...	...	-2,892	-6,746	-6,946	-8,421	-8,599	-8,245	-8,636	-9,036	-17,580	-61,022
Implement international enforcement, reform deferral, and other tax reform policies	...	...	10,000	-15,000	-20,000	-25,000	-28,000	-27,000	-26,000	-29,000	-30,000	-70,000	-210,000
Require information reporting for rental payments	...	-319	-319	-317	-274	-290	-416	-426	-445	-465	-495	-1,519	-4,009
Eliminate oil and gas company preferences:													
Levy excise tax on Gulf of Mexico oil and gas (hents excess royalty relief)	...	...	-642	-622	-542	-526	-537	-510	-632	-649	-682	-2,273	-6,282
Repeal enhanced oil recovery credit[4]	...	...	...	...	...	...	...	...	...	...	...	...	...
Repeal marginal well tax credit[4]	...	...	...	...	...	...	...	...	...	...	...	...	...
Repeal expensing of intangible drilling costs	...	...	-347	-595	-606	-385	-265	-226	-237	-260	-498	-1,953	-3,349
Repeal deduction for tertiary injectants	...	...	-5	-9	-9	-8	-7	-6	-6	-6	-5	-31	-62

Table S–6. Mandatory and Receipt Proposals—Continued

(Deficit increases (+) or decreases (–) in millions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010–2014	Totals 2010–2019
Mandatory Initiatives and Savings:*													
Agriculture:													
Reduce direct payments to farms with sales above $500,000	...	–85	–180	–605	–1,255	–1,275	–1,225	–1,225	–1,225	–1,225	–1,225	–3,640	–8,765
Reduce Crop Insurance premiums/underwriting gains and increase fees	..	...	–429	–427	–505	–510	–610	–620	–637	–634	–642	–2,050	–5,164
Reform payments to high-income farmers	...	–48	–34	–10	–9	–7	–5	–4	–3	–3	–3	–108	–126
Eliminate Cotton Storage payments	...	–52	–54	–56	–56	–57	–57	–58	–58	–59	–59	–279	–570
Reauthorize Child Nutrition	...	850	1,600	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	4,550	9,600
Reform Market Access Program	...	–4	–31	–40	–40	–40	–40	–40	–40	–40	–40	–159	–355
Total, Agriculture	...	659	–25	–158	–925	–929	–937	–947	–963	–961	–969	–1,685	–6,182
Defense:													
Implement concurrent receipt policy													
Effect on military retirement	...	194	318	419	521	574	607	640	673	710	749	2,026	5,405
Annual payments to the Military Retirement Fund (non-PAYGO)	...	389	374	360	402	415	429	444	459	475	491	1,940	4,241
Military Retirement Fund offsetting receipts (non-PAYGO)	...	–389	–374	–360	–402	–415	–429	–444	–459	–475	–491	–1,940	–4,241
Total, Defense	...	194	318	419	521	574	607	640	673	710	749	2,026	5,405
Education:													
Make Pell Grant funding mandatory and increase and index maximum awards	...	7	6,625	9,729	11,298	14,159	12,445	13,645	14,490	16,197	17,804	41,809	116,384
Eliminate entitlements for financial intermediaries under the Family Federal Education Loan Program	...	–4,123	–6,577	–5,653	–4,196	–2,717	–1,653	–1,392	–1,040	–1,056	–1,292	–24,258	–17,543
Modernize Perkins loans	...	–589	–570	–607	–644	–692	–686	–677	–674	–659	–633	–3,192	–6,480
Create a new College Access and Completion Fund	...	100	500	500	500	500	400	...	...	...	...	2,000	2,500
Total, Education	...	–4,584	–23	4,168	7,048	10,241	8,126	6,580	9,567	10,580	13,909	14,469	68,281
Energy:													
Repeal ultra-deepwater oil and gas research and development program	...	–20	–40	–50	–50	–50	–30	–10	...	...	...	–210	–250
Health and Human Services (HHS):													
Create nurse home visitation program	...	87	213	362	528	710	904	1,112	1,332	1,564	1,753	1,900	8,565
Extend TANF supplemental grants	..	..	319	319	319	319	319	319	319	319	319	1,276	2,871
Create a LIHEAP trigger	...	329	414	437	450	456	470	480	490	490	456	2,080	4,343
Total, HHS	...	416	946	1,118	1,297	1,479	1,693	1,911	2,101	2,373	2,522	5,256	15,766

Table S–6. Mandatory and Receipt Proposals—Continued

(Deficit increases (+) or decreases (–) in millions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010–2014	Totals 2010–2019
Repeal partner tax exception for working interests in oil and natural gas projection	...	...	–8	–5	–6	–6	–6	–6	–6	–6	–6	–19	–49
Repeal manufacturing tax deduction for oil and natural gas companies	...	...	–757	–1,311	–1,392	–1,464	–1,531	–1,600	–1,670	–1,745	–1,823	–4,924	–13,293
Increase geological and geophysical amortization period for independent producers to seven years	...	...	–41	–154	–240	–250	–167	–140	–91	–58	–47	–648	–1,188
Repeal percentage depletion for oil and natural gas	...	...	–216	–792	–925	–960	–996	–1,033	–1,065	–1,091	–1,112	–2,893	–8,291
Subtotal, eliminate oil and gas company preferences	...	...	–2,950	–3,448	–3,540	–3,592	–3,533	–3,521	–3,707	–3,819	–4,165	–12,731	–31,476
Eliminate Advanced Extract Income Tax Credit*	...	–565	–163	8	–10	–16	–20	–23	–24	–25	–25	–769	–688
Total, other revenue changes and loophole closers	–23	–977	–18,647	–28,044	–37,089	–42,906	–46,717	–44,460	–45,202	–46,705	–48,000	–125,663	–351,667
Upper-income tax provisions dedicated to deficit reduction:													
Reinstate the 36 percent and 39.6 percent rates for those taxpayers earning over $250,000 (married) and $200,000 (single)	...	...	–15,818	–29,604	–34,795	–35,854	–38,425	–41,268	–43,020	–44,217	–51,676	–113,870	–338,760
Reinstate the personal exemption phaseout and limitation on itemized deductions for those taxpayers earning over $250,000 (married) and $200,000 (single)	...	...	–7,227	–13,752	–17,848	–18,382	–20,841	–22,364	–23,985	–25,491	–26,884	–62,210	–179,648
Impose 28 percent rate on capital gains and dividends for those taxpayers earning over $250,000 (married) and $200,000 (single)	192	–1,192	–5,416	–8,854	–13,549	–12,215	–15,322	–16,007	–17,084	–16,925	–18,249	–39,959	–118,116
Total, upper-income tax provisions dedicated to deficit reduction	192	–1,192	–28,461	–52,210	–66,152	–67,271	–74,588	–80,039	–84,089	–86,633	–96,809	–215,039	–636,524
Total, tax provisions	**26,637**	**46,015**	**–25,704**	**13,385**	**1,091**	**–7,013**	**–10,015**	**–11,776**	**–15,068**	**–19,395**	**–22,419**	**17,589**	**–49,904**
Climate Revenues:													
Dedicated to climate policy (clean energy technologies)	...	...	...	–15,000	–15,000	–15,000	–15,000	–15,000	–15,000	–15,000	–15,000	–45,000	–120,000
Dedicated to Making Work Pay	...	...	...	–63,569	–64,119	–64,681	–65,291	–66,001	–66,871	–67,192	–67,973	–192,492	–525,721
Total, climate revenues*	...	...	...	**–78,569**	**–79,119**	**–79,681**	**–80,291**	**–81,001**	**–81,871**	**–82,207**	**–82,973**	**–237,492**	**–645,721**

Table S–6. Mandatory and Receipt Proposals—Continued

(Deficit increases (+) or decreases (–) in millions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010–2014	Totals 2010–2019
Total, Veterans Affairs	..	–94	–99	–104	–110	–117	–126	–135	–145	–155	–167	–524	–1,252
Federal Communications Commission (FCC):													
Provide permanent auction authority	....	....	....	....	–200	–200	–200	–200	–200	–200	–200	–400	–1,400
Auction domestic satellite spectrum	....	–100	–75	–25	....	....	....	....	....	....	....	–200	–200
Total, FCC	..	–100	–75	–25	–200	–200	–200	–200	–200	–200	–200	–600	–1,600
Postal Service:													
Realign USPS employer/employee benefit contributions	....	–752	–814	–830	–870	–913	–959	–1,007	–1,056	–1,110	–1,167	–4,179	–9,478
Social Security Administration:													
Program integrity: require States and localities to provide persons information (not subject to PAYGO)	....	....	....	....	–186	–362	–480	–512	–472	–449	–415	–528	–2,869
Multi-Agency:													
Implement program integrity allocation adjustments[1]	....	–1,572	–3,536	–5,587	–6,064	–10,881	–6,053	–4,373	–3,382	–2,620	–2,440	–29,230	–48,498
Total, mandatory initiatives and savings	**250,205**	**–4,347**	**5,690**	**1,206**	**–1,215**	**–1,661**	**2,190**	**5,853**	**7,854**	**10,712**	**12,116**	**–975**	**37,928**
Enact User Fees:[2]													
Agriculture:													
Grain Inspection, Packers, and Stockyards Administration (GIPSA) fee	....	–27	–30	–30	–31	–31	–31	–32	–32	–32	–33	–149	–309
Animal Plant and Health Inspection Service (APHIS) fees	....	–26	–27	–27	–28	–29	–30	–31	–32	–33	–34	–131	–291
Food Safety and Inspection Service (FSIS) performance fee	....	–4	–4	–4	–4	–4	–4	–5	–5	–5	–5	–20	–44
Corps of Engineers:													
Replace the inland waterways fuel tax with a lock usage fee (receipt effect)	....	–158	–158	–107	–195	–129	–116	–115	–115	–114	–112	–607	–1,259
Environmental Protection Agency:													
Pesticide and pre-manufacture notification (PMN) fees	....	–52	–56	–55	–45	–47	–47	–49	–49	–51	–51	–256	–502
FCC:													
Spectrum license user fee	–10	–200	–300	–425	–550	–550	–550	–550	–550	–550	–550	–2,025	–4,775
HHS (Centers for Medicare and Medicaid Services):													
Survey and certification recert user fee[4]	....	....	....	....	....	....	....	....	....	....	....	....	....
Survey and certification recertification user fee[4]	....	....	....	....	....	....	....	....	....	....	....	....	....
Total, user fees	**–10**	**–531**	**–645**	**–648**	**–852**	**–790**	**–778**	**–782**	**–785**	**–786**	**–785**	**–3,187**	**–7,186**
Total, mandatory and receipt proposals and climate policies	**270,802**	**41,936**	**–20,639**	**–64,865**	**–80,094**	**–90,135**	**–86,584**	**–88,126**	**–89,658**	**–90,670**	**–94,797**	**–215,598**	**–664,957**

Table S–6. Mandatory and Receipt Proposals—Continued

(Deficit increases (+) or decreases (–) in million dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010–2014	Totals 2010–2019
Housing and Urban Development:													
Provide funding for the Affordable Housing Trust Fund	....	20	140	250	250	240	100	....	....	....	....	900	1,000
Expand HOPE for Homeowners program	225	1,315	960	....	....	....	....	....	....	....	....	2,275	2,275
Total, Housing and Urban Development	225	1,335	1,040	250	250	240	100	....	....	....	....	3,175	3,275
Interior:													
Increase return from minerals on Federal lands:													
Fee on nonproducing leases ("use or lose")	....	–122	–121	–145	–107	–109	–112	–114	–116	–119	–121	–574	–1,166
Abandoned Mine Lands (AML) Payments to Certified States	....	–242	–164	–208	–210	–206	–90	–90	–94	–158	–161	–928	–1,520
Repeal Energy Policy Act fee prohibition and mandatory permit funds	....	–42	–32	–32	–32	–32	–32	–9	–9	–9	–9	–171	–259
Reserve funds for insular affairs assistance	....	7	6	6	5	5	4	4	4	4	4	28	45
Recover Fish Slough project cost	....	–21	–23	–23	–23	–23	–23	–23	–23	–23	–23	–115	–230
Total, Interior	....	–325	–333	–373	–366	–366	–253	–232	–238	–305	–311	–1,761	–3,130
Labor:													
Reform Trade Adjustment Assistance	....	....	116	360	472	550	584	654	679	649	678	1,498	4,642
Change Extended Unemployment Insurance benefits trigger	....	....	8,700	2,600	600	1,500	1,700	1,700	1,600	2,100	12,100	21,600	
Implement Unemployment Insurance integrity legislation[1]	....	....	–579	–573	–384	–394	–242	238	–341	–894	–39	–1,869	–2,617
Total, Labor	....	....	8,237	2,387	688	756	1,051	2,066	2,084	3,043	2,768	17,029	23,625
Treasury:													
Create gleaseholder for potential additional financial stabilization effect	250,000	....	....	....	....	....	....	....	....	....	....	....	....
Levy payments to federal contractors with delinquent tax debt (receipt effect)[1]	....	–49	–73	–77	–69	–64	–68	–92	–96	–100	–105	–263	–644
Revise Terrorism Risk Insurance program[1]	....	119	134	408	–164	–800	–309	–193	–99	–18	7	–426	–1,054
Make technical corrections to JOBS Act (receipt effect)[1]	....	–19	–28	–28	–32	–31	–32	–33	–34	–35	–36	–117	–302
Total, Treasury	250,000	42	33	302	–278	–1,895	–409	–318	–229	–153	–149	–806	–2,250
Veterans Affairs:													
Implement concurrent receipt policy:													
Effect on Veterans disability payments	....	47	49	51	53	54	54	54	53	53	52	254	550
Use discretionary funds for contract examinations for disability compensation eligibility (not subject to PAYGO)	....	–151	–149	–155	–163	–171	–180	–189	–198	–208	–219	–778	–1,773

Table S-6. Mandatory and Receipt Proposals—Continued

(Deficit increases (+) or decreases (−) in millions of dollars)

Health Reform Reserve Fund

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Totals 2010–2014	Totals 2010–2019
Aligning incentives toward quality:													
Encourage hospitals serving Medicare beneficiaries to reduce readmission rates	....	....	....	−680	−840	−930	−1,020	−1,110	−1,200	−1,290	−1,770	−2,450	−8,450
Create hospital quality incentive payments	....	....	−660	−970	−940	−1,180	−1,540	−1,700	−1,830	−1,960	−2,060	−3,870	−12,960
Encourage primary care physicians to administer the flu vaccine to Medicare beneficiaries	....	*	*	*	*	*	*	*	*	*	*	*	*
Enable physicians to form voluntary groups that coordinate care for Medicare beneficiaries and to receive performance-based payments for the coordinated care	....	....	*	*	*	*	*	*	*	*	*	*	*
Total, aligning incentives toward quality	....	....	−660	−1,250	−1,880	−2,090	−2,560	−2,810	−3,030	−3,240	−3,460	−6,430	−20,510
Promoting efficiency and accountability:													
Establish competitive bidding for Medicare diagnostic tests	....	....	....	−11,240	−16,610	−19,380	−21,550	−23,940	−26,140	−28,670	−30,270	−46,830	−178,620
Promote efficient provision of acute care through bundled Medicare payments for inpatient hospital and post-acute settings	....	....	....	....	−180	−770	−1,910	−2,790	−3,750	−4,280	−4,290	−950	−17,840
Adjust payments for medical education for physician-owned specialty hospitals	....	*	*	*	*	*	*	*	*	*	*	*	*
Ensure that Medicare makes appropriate payments for imaging services through the use of radiology benefit managers	....	....	−10	−20	−30	−30	−30	−30	−40	−40	−50	−70	−260
Provide private sector enhancements to ensure Medicare pays accurately	....	−60	−110	−160	−170	−200	−220	−240	−260	−280	−310	−720	−2,040
Promote cost-effective purchase and delivery of Medicaid prescription drugs by (1) increasing the Medicaid rebate amounts, (2) extending to and collecting rebates on behalf of managed care plans, and (3) applying rebates to new formulations of existing drugs	....	−1,165	−1,630	−1,690	−1,770	−1,930	−2,042	−2,130	−2,360	−2,630	−2,540	−8,153	−19,555
Promote increased generic medication utilization by establishing a pathway for FDA approval of generic biologics	....	....	....	....	20	−10	−680	−1,590	−1,930	−2,330	−1,770	10	−8,240
Expand availability of family planning services, supports Medicaid	....	5	5	....	−5	−15	−30	−25	−35	−45	−65	−10	−180
Improve payments under Medicaid for drugs as part of the National Correct Coding Initiative (NCCI) rules	....	−10	−25	−40	−45	−55	−75	−85	−90	−95	−100	−175	−620
Improve Medicare home health payments to align with costs	....	−605	−2,840	−3,090	−3,350	−3,710	−4,080	−4,450	−4,780	−5,120	−5,480	−13,160	−77,070
Reallocate Medicare and Medicaid Improvement Funds	....	....	....	....	−5,810	−5,940	−6,070	−6,090	−30	....	−5,640	−23,840	

Table S–7. Funding Levels for Appropriated ("Discretionary") Programs by Agency

(Budget authority in billions of dollars)

	2009	2009-2010	2010	Outlayes					Totals	
	Estimate	Recovery Act	Request	2011	2012	2013	2014	2010-2014	2010-2019
Base Discretionary Policy by Agency:									
Departments:									
Agriculture	23.9	0.9	26.0	27.2	27.0	28.4	28.1	135.8	299.0
Commerce	8.3	7.9	13.8	8.1	7.5	6.5	6.7	46.9	94.3
Defense (DOD – excluding Overseas Contingency Operations)	513.3	7.4	531.7	541.8	550.7	561.1	574.6	2,761.9	5,854.9
Education[1]	41.4	83.1	46.7	53.6	58.5	61.6	64.5	284.9	596.4
Energy	26.4	35.7	26.3	26.3	27.2	27.7	28.3	135.8	286.9
Health and Human Services[1]	80.1	22.4	78.7	83.7	85.5	87.2	90.7	426.1	908.5
Homeland Security	42.1	2.9	42.7	42.4	43.9	41.5	40.9	209.3	436.3
Housing and Urban Development	49.1	13.6	47.8	47.6	47.0	47.0	48.2	238.3	498.6
Interior	14.3	3.0	12.0	12.3	12.5	12.7	13.0	62.4	131.5
Justice	25.6	4.0	32.9	27.7	27.9	28.0	28.2	135.7	284.8
Labor	12.7	4.8	13.3	13.4	13.5	13.6	13.7	67.5	139.8
State and Other International Programs[2]	36.7	0.6	51.7	56.8	60.3	64.8	69.3	302.1	661.7
Transportation[3]	30.6	48.3	72.5	64.2	64.1	65.2	66.3	332.3	681.8
Treasury	12.7	0.3	13.3	13.7	14.1	14.7	15.3	71.1	157.8
Veterans Affairs[4]	47.6	1.4	52.5	53.7	55.1	56.6	58.2	276.2	568.6
Major Agencies:									
Corps of Engineers	5.3	4.6	5.1	5.2	5.2	5.3	5.5	26.3	50.6
Environmental Protection Agency	7.8	7.2	10.6	10.6	10.7	10.8	10.8	53.4	101.6
General Services Administration	0.7	5.9	0.6	0.7	0.6	0.6	0.6	3.2	6.4
National Aeronautics and Space Administration	17.6	1.0	18.7	18.6	18.6	18.5	18.3	93.4	191.6
National Science Foundation	6.9	3.0	7.0	7.2	8.5	8.1	8.7	41.6	87.9
Small Business Administration	0.7	0.7	0.7	0.8	0.8	0.8	1.0	4.1	9.6
Social Security Administration[5]	8.8	1.1	9.7	10.5	11.0	11.6	12.2	56.9	122.3
Corporation for National and Community Service	0.9	0.2	1.1	1.3	1.7	2.0	2.4	8.5	23.9
National Infrastructure Bank	...	...	5.0	5.0	5.0	5.0	5.0	25.0	25.2
Climate Policy (Clean Energy Technologies)	...	...	...	...	15.0	15.0	15.0	45.0	120.0
Other Agencies	19.1	0.2	18.8	18.8	18.6	18.4	18.4	93.0	182.3
Total, Base Discretionary	1,061.6	207.0	1,132.8	1,150.3	1,190.2	1,216.1	1,248.2	6,938.3	12,645.2

Table S–6. Mandatory and Receipt Proposals—Continued

(Deficit increases (+) or decreases (–), in billions of dollars)

Note: For receipt effects, positive figures indicate lower receipts. For outlay effects, positive figures indicate higher outlays. For net costs, positive figures indicate higher deficits.

[1]Annual effects unless otherwise noted.

[2]The estimates for this proposal include effects on outlays. The outlay effects included in the totals above are listed below:

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2010-2014	2010-2019
Provide Making Work Pay tax credit	...	...	782	22,158	22,429	22,400	22,361	22,824	22,774	23,172	23,439	68,116	163,099
Expand Earned Income Tax Credit	...	...	...	3,805	3,882	2,861	3,959	4,014	4,667	4,188	4,248	13,498	32,669
Expand refundability of the Child Tax Credit	...	...	...	5,714	8,616	9,605	9,762	9,398	8,902	8,505	9,119	23,935	70,401
Expand college credit and automatic enrollment in Ohio and Arizona	...	...	57	743	945	895	909	940	976	1,009	1,048	3,544	7,416
Provide American Opportunity Tax Credit	...	...	...	2,908	3,256	3,529	4,144	4,645	4,896	5,048	5,210	9,813	33,820
Continue remaining expiring provisions through calendar year 2010	...	62	21	...	...	...	...	...	...	...	...	83	83
Eliminate Advanced Earned Income Tax Credit	...	–263	–103	...	–10	–19	–20	–20	–20	–21	–23	–793	–895
Total outlay effects of receipt proposals	...	–201	756	30,928	39,112	39,269	40,215	41,296	41,915	42,301	43,037	117,498	326,594

[3]The Budget proposes repealing some aviation excise taxes and enacting three taxes with direct user charges. The net of repealing the excise taxes is reflected here.

The user charges are considered discretionary and offset discretionary budget authority and outlays.

[4]This proposal is estimated to have zero outlay effect under the Administration's current projections for energy prices.

[5]Short-term tax those proceeds from auctioning emission allowances that are reserved for clean energy technology initiatives and to compensate families through the tax system. The tax proceeds are included in the grand totals as receipts, though they could alternatively be considered offsets to outlays. All additional net proceeds will be used to further compensate the public.

[6]Outlay effects unless otherwise noted.

[7]The estimates for this proposal include effects on receipts. The receipt effects included in the totals above are listed below:

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2010-2014	2010-2019
Implement Unemployment Insurance integrity legislation:													
Subject to PAYGO	...	...	–20	–24	–22	–21	–19	–18	–16	–19	–110	–106	–356
Not subject to PAYGO	...	...	–2	6	18	23	167	192	1,042	427	71	2,136	2,134
Secure Terrorism Risk Insurance program	...	110	171	154	99	–440	252	325	314	266	174	458	1,790
Levy penalties to federal contractors with delinquent tax debt	...	–19	–73	–77	–80	–84	–88	–92	–96	–100	–105	363	644
Make technical correction to 2008 Act	...	–19	–28	–29	–30	–31	–32	–33	–34	–35	–36	–137	–307
Implement program integrity education adjustments – IRS	...	–200	–1,119	–2,349	–2,684	–3,729	–1,460	–617	–412	–371	–387	–13,580	–18,640
Total receipt effects of mandatory proposals	...	–148	–1,051	–1,368	–2,655	–4,181	–1,181	–219	–104	164	46	–12,441	–14,997

[8]Spending of proposed mandatory user fee equals projected collections, for a net zero impact.

Table S-8. Comparison of Economic Assumptions

(Calendar years)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Nominal GDP:												
2010 Budget	14,281	14,291	14,992	15,798	16,711	17,729	18,860	19,415	20,379	21,461	22,124	23,108
Congressional Budget Office (January 2009)[1]	14,304	14,241	14,591	15,347	16,203	17,280	18,211	19,077	19,909	20,749	21,617	22,500
February Blue Chip Consensus	14,282	14,176	14,676	15,305	16,184	17,009	17,859	18,734	19,643	20.597	21.598	22,648
Real GDP:[2]												
2010 Budget	1.3	-1.2	3.2	4.0	4.6	4.2	3.9	3.6	3.6	3.6	3.6	3.6
Congressional Budget Office (January 2009)[1]	1.2	-2.2	1.5	4.2	4.4	4.1	3.5	2.8	2.5	2.3	2.2	2.2
February Blue Chip Consensus	1.3	-1.9	2.1	2.9	2.9	2.8	2.7	2.7	2.7	2.7	2.7	2.7
GDP Price Index:[2]												
2010 Budget	2.2	1.2	1.1	1.5	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Congressional Budget Office (January 2009)[1]	2.4	1.8	0.9	1.0	1.7	1.8	1.8	1.9	1.8	1.9	1.9	1.9
February Blue Chip Consensus	2.2	1.0	1.3	1.9	2.2	2.2	2.2	2.1	2.1	2.1	2.1	2.1
Consumer Price Index (CPI-U):[2]												
2010 Budget	3.8	-0.6	1.6	1.8	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Congressional Budget Office (January 2009)[1]	4.1	0.4	1.7	1.8	2.0	2.2	2.2	2.2	2.2	2.2	2.2	2.2
February Blue Chip Consensus	3.8	-0.8	1.8	2.4	2.5	2.4	2.5	2.4	2.3	2.3	2.3	2.2
Unemployment Rate:[3]												
2010 Budget	5.8	8.1	7.9	7.1	6.0	5.2	5.0	5.0	5.0	5.0	5.0	5.0
Congressional Budget Office (January 2009)[1]	5.7	8.2	9.0	8.0	6.3	5.6	5.1	4.9	4.8	4.8	4.8	4.8
February Blue Chip Consensus	5.8	8.3	8.7	8.3	5.5	5.3	5.2	5.1	5.1	5.1	5.1	5.1
Interest Rates:[3]												
91-Day Treasury Bills (discount basis):												
2010 Budget	1.4	0.2	1.6	3.4	3.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Congressional Budget Office (January 2009)[1]	1.4	0.2	0.6	2.1	4.0	4.7	4.7	4.7	4.7	4.7	4.7	4.7
February Blue Chip Consensus	1.4	0.3	1.1	4.2	4.3	4.4	4.4	4.4	4.4	4.4	4.4	4.4
10-Year Treasury Notes:												
2010 Budget	3.7	2.8	4.0	4.8	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Congressional Budget Office (January 2009)[1]	3.7	3.0	3.5	3.6	4.7	5.4	5.4	5.4	5.4	5.4	5.4	5.4
February Blue Chip Consensus	3.7	2.8	3.6	5.1	5.2	5.3	5.2	5.2	5.2	5.2	5.2	5.2

Sources: Administration; CBO; *The Budget and Economic Outlook: January 2009*; February 2009 *Blue Chip Economic Indicators*, Aspen Publishers, Inc. (2011-2019 from October 2008 Blue Chip long run estimates).

[1] CBO economic projections do not include the effects of the American Recovery and Reinvestment Act of 2009.
[2] Year-over-year percent change.
[3] Annual average, percent.

Table S-7. Funding Levels for Appropriated ("Discretionary") Programs by Agency—Continued

	Budget Authority (billions of dollars)								
	2008	2009-2010	2010	Outlays				Totals	
	Enacted	Recovery Act	Request	2011	2012	2013	2014	2011-2014	2010-2019
Other Discretionary Costs:									
Funding for Overseas Contingency Operations (OCO)—Enacted[1]	46.6								
Funding for Overseas Contingency Operations (OCO)—Proposed[1]	75.6		120.0	50.8	48.0	34.0	34.0	216.4	580.0
International Supplemental Funding—Enacted[1]	4.2								
International Supplemental Funding—Proposed[1]	7.1								
Overseas Costs:									
Energy	7.6								
Corps of Engineers	4.6								
Veterans Affairs and Other	0.8								
Total, Overseas Operations, International, and Overseas Costs	146.7		120.0	50.8	48.0	34.0	34.0	216.8	580.0
Grand Total, Discretionary Funding	1,379.7	317.4	1,342.8	1,280.3	1,341.3	1,366.7	1,390.9	5,436.1	13,345.1

Adjusted for advance appropriations. 2009 funding is 2010 level. All numbers include funding for DOD Grants.
Funding from the Hospital Insurance and Supplementary Medical Insurance trust funds for administrative expenses carried by the Social Security Administration that is not included in the budget totals of the Federal Hospital Insurance and Supplementary Medical Insurance trust funds is included in the totals for Other Independent Agencies.
The Administration requests that Congress authorize increases in the amount the Government is quota subscription in the International Monetary Fund, stated as a net outlay $8 billion. Because this is an exchange of financial assets, the Administration does not propose to score the transaction as discretionary budget authority or outlays.
The Administration proposes that all discretionary budgetary resources for transportation be scored as discretionary budget authority, as is the case for other programs.
Starting in 2011, the Budget proposes to replace some aviation excise taxes with direct user charges. The direct user charges are considered to be discretionary and offset the aviation excise tax receipts. The net effect of the proposal is to increase discretionary budget authority and receipts. The net effect on the deficit is zero. The net effect on the budget authority starting in 2011 which is reflected here, is also reflected in receipt totals. This is shown in Table S-4.
The Veterans Affairs total is net of certain user collections.
The Budget includes placeholder estimates of $50 billion per year for Overseas Contingency Operations in 2011 and beyond. These estimates do not reflect any specific policy decisions.
Enacted and proposed supplementals include emergency food aid funded by the Department of Agriculture.

Table S-9. Federal Government Financing and Debt

(In billions of dollars)

	Actual 2008	Estimate 2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Financing:												
Unified budget deficit	459	1,752	1,171	912	581	533	570	583	627	626	624	712
Other transactions affecting borrowing from the public:												
Changes in financial assets and liabilities[1]												
Change in Treasury operating cash balance	196	−392	...	...	...	...	...	...	...	...	...	...
Net disbursements of credit financing accounts:												
Direct loan accounts	27	452	57	68	80	82	75	77	71	68	67	95
Guaranteed loan accounts	8	2	−8	−3	4	6	7	6	3	1	−4	−6
Troubled Asset Relief Program (TARP) equity purchase accounts	...	202	−18	−8	−53	−18	−25	−9	−5	−2	−2	4
Financing accounts for potential additional financial stabilization efforts	...	132	−59	−60	−61	−62	−63	−65	−66	−67	−68	9
Net purchases of non-Federal securities by the National Railroad Retirement Investment Trust (NRRIT)	−7	−6	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1
Net change in other financing assets and liabilities[2]	−12	...	...	...	...	...	...	...	...	...	...	...
Subtotal, changes in financial assets and liabilities	240	810	−27	15	−32	−12	−5	7	2	−1	−9	102
Seigniorage on coins	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1
Total, other transactions affecting borrowing from the public	239	810	−27	15	−32	−12	−5	7	2	−2	−9	101
Total, requirements to borrow from the public (equals change in debt held by the public)	698	2,562	1,144	927	549	520	565	589	634	624	625	813
Changes in Debt Subject to Statutory Limitation:												
Change in debt held by the public	698	2,562	1,144	927	549	520	565	589	634	624	625	813
Change in debt held by Government accounts	987	157	229	267	371	402	384	372	354	358	364	328
Change in other factors	3	2	1	1	2	2	1	2	2	2	2	1
Total, change in debt subject to statutory limitation	1,689	2,720	1,374	1,196	923	925	950	963	984	995	991	1,142
Debt Subject to Statutory Limitation, End of Year:												
Debt issued by Treasury	9,963	12,619	14,003	15,248	16,169	17,093	18,042	19,003	19,996	20,990	21,981	23,122
Adjustment for discount, premium, and coverage[3]	−5	1	1	0	3	5	6	7	8	9	9	10
Total, debt subject to statutory limitation[4]	9,960	12,620	14,004	15,252	16,172	17,097	18,048	19,010	20,004	20,999	21,990	23,132

Table S-9. Federal Government Financing and Debt—Continued

(In billions of dollars)

	Actual 2008	Estimate 2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Debt Outstanding, End of Year:												
Gross Federal debt:[5]												
Debt issued by Treasury	9,961	12,619	14,053	15,248	16,169	17,093	18,042	19,003	19,996	20,990	21,981	23,122
Debt issued by other agencies	25	25	25	24	24	23	23	23	22	20	18	18
Total, gross Federal debt	9,986	12,704	14,078	15,272	16,193	17,116	18,065	19,026	20,018	21,011	21,999	23,140
Held by:												
Debt held by Government accounts	4,182	4,340	4,569	4,837	5,208	5,610	5,966	6,367	6,720	7,078	7,443	7,770
Debt held by the public[6]	5,803	8,364	9,509	10,436	10,985	11,505	12,099	12,659	13,297	13,932	14,557	15,370
Debt Held by the Public Net of Financial Assets:												
Debt held by the public	5,803	8,364	9,509	10,436	10,985	11,505	12,099	12,659	13,297	13,932	14,557	15,370
Less financial assets net of liabilities:												
Treasury operating cash balance	272	70	70	70	70	70	70	70	70	70	70	70
Credit financing account balances:												
Direct loan accounts	196	678	734	825	902	985	1,063	1,140	1,211	1,279	1,346	1,441
Guaranteed loan accounts	−43	−40	−48	−51	−48	−42	−34	−29	−25	−26	−30	−35
TARP equity purchase accounts	..	202	186	178	125	87	62	53	48	46	44	49
Financing accounts for potential additional financial stabilization efforts	....	232	374	314	253	192	127	63	−3	−70	−138	−129
Government-Sponsored Enterprise preferred stock	2	108	149	173	173	173	173	173	173	173	173	173
Non-Federal securities held by NRRIT	23	19	18	16	16	15	14	13	11	10	9	7
Other assets net of liabilities	48	−46	−46	−46	−46	−46	−46	−46	−46	−46	−46	−46
Total, financial assets net of liabilities	505	1,422	1,438	1,476	1,444	1,433	1,428	1,435	1,438	1,436	1,428	1,530
Debt held by the public net of financial assets	5,297	6,942	8,072	8,960	9,541	10,072	10,647	11,224	11,860	12,495	13,129	13,840

[1] A decrease in assets, such as the Treasury operating cash balance, is a means of financing a deficit and therefore has a negative sign. An increase in liabilities, such as checks outstanding, is also a means of financing a deficit and therefore also has a negative sign.
[2] Includes checks outstanding, includes accrued interest payable on Treasury debt, unmatured deposit fund balances, allocations of special drawing rights, and other liability accounts; and, as an offset, cash and monetary assets (other than the Treasury operating cash balance), other asset accounts, and profit on sale of gold.
[3] Consists mainly of debt issued by the Federal Financing Bank (which is not subject to limit), debt held by the Federal Financing Bank, the unamortized discount (less premium) on public issues of Treasury notes and bonds (other than zero-coupon bonds), and the unrealized discount on Government account series securities.
[4] The statutory debt limit is $12,104 billion, enacted on February 17, 2009.
[5] Treasury securities held by the public and zero-coupon bonds held by Government accounts are almost all measured at sales price plus amortized discount or less unamortized premium. Agency debt securities are almost all measured at face value. Treasury securities in the Government account series are otherwise measured at face value less unrealized discount (if any).
[6] At the end of 2008, the Federal Reserve Banks held $491.1 billion of Federal securities and the rest of the public held $9,311.6 billion. Data held by the Federal Reserve Banks is not estimated for future years.

1 answers to my questions, say, within two weeks?

2 Secretary Chu. I will certainly try, Senator.

3 Senator Wyden. And if you would send those through the

4 Chairman and the Ranking Minority Member so that all members

5 of the committee could have it, that would be helpful.

6 Thank you, Mr. Chairman.

7 Chairman Conrad. I thank the Senator.

8 Senator Enzi, please.

9 Senator Enzi. Thank you, Mr. Chairman.

10 Mr. Secretary, I am very impressed with your answers

11 and your range of knowledge and all the things that you said

12 here today, and particularly your emphasis on energy

13 research. I realize from your background that that would be

14 an emphasis, but Wyoming is particularly interested in the

15 research and have made some huge commitments to research.

16 One of their commitments is based on abandoned mine land

17 money.

18 There was a tax that was going to expire about three

19 years ago and of that tax, half of it would go to solve

20 abandoned mine land problems in the East and half would be

21 returned to the State where the coal was dug to take care of

22 the abandoned mine land projects, and Wyoming was one of the

23 States that went ahead and solved a lot of those projects

24 even before the government released the money, which they

25 didn't do for about 30 years. Since the coal tax was going

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According to the Internal Revenue Service (IRS) website, http://www.irs.gov/newsroom/article/0,,id=204447,00.html, for 2009 and 2010, the Making Work Pay provision of the American Recovery and Reinvestment Act will provide a refundable tax credit of up to $400 for working individuals and $800 for married taxpayers filing joint returns. This tax credit will be calculated at a rate of 6.2 percent of earned income and will phase out for taxpayers with adjusted gross income in excess of $75,000, or $150,000 for married couples filing jointly. After 2010, the amount of the tax credit can be reevaluated. For more specific information on the particulars raised with this issue, please contact the IRS, which administers this specific tax credit.

1 answers to my questions, say, within two weeks?

2 Secretary Chu. I will certainly try, Senator.

3 Senator Wyden. And if you would send those through the

4 Chairman and the Ranking Minority Member so that all members

5 of the committee could have it, that would be helpful.

6 Thank you, Mr. Chairman.

7 Chairman Conrad. I thank the Senator.

8 Senator Enzi, please.

9 Senator Enzi. Thank you, Mr. Chairman.

10 Mr. Secretary, I am very impressed with your answers

11 and your range of knowledge and all the things that you said

12 here today, and particularly your emphasis on energy

13 research. I realize from your background that that would be

14 an emphasis, but Wyoming is particularly interested in the

15 research and have made some huge commitments to research.

16 One of their commitments is based on abandoned mine land

17 money.

18 There was a tax that was going to expire about three

19 years ago and of that tax, half of it would go to solve

20 abandoned mine land problems in the East and half would be

21 returned to the State where the coal was dug to take care of

22 the abandoned mine land projects, and Wyoming was one of the

23 States that went ahead and solved a lot of those projects

24 even before the government released the money, which they

25 didn't do for about 30 years. Since the coal tax was going

1 to run out, we got together an interesting coalition of
2 people and extended that tax, but with the promise that that
3 money would be coming back to Wyoming, and that is what the
4 legislature has committed to energy research for our State.
5 Now, the budget calls for eliminating the return to the
6 States that in good faith made that operation, and one of
7 the things I am worried about is in the future, if we are
8 putting together unique coalitions like that, if the
9 government will be trusted if that happens. I was hoping
10 that you might take a role in seeing that our research money
11 continues to come. It is money that was stolen from Wyoming
12 for 30 years before we were able to get a release on it, so
13 it is a fairly big chunk of money now. But if it doesn't
14 come through, we won't be able to do the research that the
15 State has already obligated to do through 2011. So I hope--
16 my question is, will you help us play a role in that?
17 Secretary Chu. Well, I will certainly look into this
18 and get back to you on that.
19 Senator Enzi. Okay. I appreciate it and understand
20 that that would be the best you would be able to do at the
21 moment, but I will look forward to visiting with you some
22 more about it.
23 I am a huge advocate of incentives working better than
24 penalties, although recognizing that sometimes penalties
25 need to be in place because there are bad actors. One of

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Pursuant to the Surface Mining Control and Reclamation Act of 1977, abandoned mine land reclamation falls under the purview of the Department of the Interior, Office of Surface Mining Reclamation and Enforcement. The Office of Surface Mining Reclamation and Enforcement is currently working with the Congress and the Administration to address this issue.

Mike Crapo

A Sustainable Energy Future: The Essential Role of Nuclear Energy

August 2008

Michael Anastasio, Director, LANL

Michael Kluse, Director, PNNL

Samuel Aronson, Director, BNL

Thom Mason, Director, ORNL

Steven Chu, Director, LBNL

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John Grossenbacher, Director, INL

Robert Rosner, Director, ANL

Thomas Hunter, Director, SNL

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A Sustainable Energy Future: The Essential Role of Nuclear Energy

The Directors of the Department of Energy (DOE) national laboratories strongly believe that nuclear energy must play a significant and growing role in our nation's — and the world's — energy portfolio. This conclusion is based on an analysis of national and international energy needs in the context of broader global energy, environmental, and security issues. This paper provides details regarding our position in relation to nuclear energy. It is intended to be used as a basis for further discussion with stakeholders to help in developing specific near-term actions as well as a coherent long-term strategy incorporating the items listed below:

- Make maximum use of the current 'fleet' of operating light-water reactors, including plant life extensions, extended fuel burnup, and power uprates.
- Establish a national priority to immediately deploy advanced light-water reactors to meet our nation's increasing energy demand, while limiting greenhouse gas emissions and continuing to provide critical support to the Nuclear Regulatory Commission (NRC).
- Employ an integrated approach to manage used nuclear fuel and high-level waste, including interim storage, licensing of the Yucca Mountain Repository as a long-term resource, and exploration of optimal future waste management options.
- Implement an aggressive research and development (R&D) program on advanced reactors, reprocessing, waste management, and fuel fabrication concepts to enable timely identification of the technological options for a sustainable closed fuel cycle.
- Pursue partnering with other countries and implementation of an international regime that discourages the spread of enrichment and reprocessing capabilities and promotes the assurance of worldwide fuel supply and effective waste management.
- Strengthen international safeguards through aggressive R&D, thereby revitalizing U.S. safeguards technology and human capital and providing for U.S. leadership to help in assuring achievement of international security objectives and nonproliferation goals.
- Form a robust public-private partnership to ensure that (1) nuclear energy plays a more significant role in energy independence and environmental health, and (2) human infrastructure is rebuilt across industry, government, and academia.
- Incorporate independent and authoritative guidance and peer review from government and nongovernment entities to ensure that the U.S. nuclear energy agenda is responsive to current and future national needs and international conditions.

BROAD ENERGY CONTEXT

Energy is vital to human civilization and underpins national security, economic prosperity, and global stability. Worldwide demand for energy is rapidly increasing and could double by 2050. At the same time, the evidence is clear that CO_2 emissions must be reduced globally. Abundant, affordable, and environmentally responsible energy must be developed, both domestically and internationally, to meet that demand.

Reducing U.S. dependence on foreign oil will provide economic and national security benefits, including both industrial competitiveness and international trade. Crude oil expenditures represent the largest deficit item to our balance of trade. To reverse the trend on energy imports, while at the same time meeting required reductions in CO_2 emissions, the United States must use energy more efficiently. Furthermore, our nation must develop and deploy multiple energy sources in the context of a strategic and comprehensive energy plan. A broad mix of energy technologies is essential to meet the growing demand.

BENEFITS OF NUCLEAR ENERGY

Today, nuclear energy provides 16 percent of the world's electricity and offers unique benefits. It is the only existing technology with capability for major expansion that can simultaneously provide stability for base-load electricity, security through reliable fuel supply, and environmental stewardship by avoiding emissions of greenhouse gases and other pollutants. Furthermore, it has proven reliability (greater than 90 percent capacity factor), exemplary safety, and operational economy through improved performance.

We believe that nuclear energy must play a significant role in our nation's — and the world's — electricity portfolio for the next 100+ years. Nuclear energy has great potential for contributing more to our broader energy needs, however. For example, nuclear energy could supplement or even supplant fossil fuels by providing the electricity for electric-powered vehicles, or it could be used to generate hydrogen for vehicles that utilize hydrogen fuel cells. Nuclear energy could also help to generate high-temperature process heat, provide a valuable input for feedstock to chemical production and aid in the production of freshwater from seawater and contaminated surface and groundwater sources.

FOCUS EFFORTS AND INVESTMENTS: WHY NOW?

There are many reasons to focus on and invest in the expansion of nuclear energy. First, time-critical clean energy needs can be met through reactor life-time extensions, higher fuel burnup, power uprates, and additional deployment of existing light-water reactor technology. Second, to maximize the benefits of nuclear energy domestically, advanced fuel cycles that cost-effectively optimize energy utilization and waste management are needed; however, there is a long lead time for developing the required technologies. Third, the United States now has a window of opportunity to influence global directions in safety, security, and nonproliferation throughout the nuclear fuel cycle. A strong, sustained, integrated effort across all three areas must begin now.

SUCCESSFUL PATH FORWARD

The directors of the DOE national laboratories remain committed to U.S. energy security and the important role that an increased nuclear energy component can and should play in strengthening our energy security. Essentials for success are a strategy that integrates across DOE as well as other federal agencies; a concentrated effort to rebuild the necessary nuclear enterprise, including a broad-based R&D effort; and engagement with industry and the international community. Key to ensuring a successful effort is decisive leadership and a strong public-private sector partnership.

Strategy and Policy Development

To facilitate that leadership, all stakeholders must work together to develop a comprehensive strategic plan that has broad, bipartisan support and clear, consistent communications among government, researchers, the international community, industrial stakeholders, and the public. The development and implementation of a strategic plan should include:

- A clear statement of national energy policies. The full range of benefits and risks involved in nuclear energy create an inextricable link between government and industry. Furthermore, government policies and programs should be harmonized with those of the private sector. This relationship must be a partnership.

- A clear differentiation between short- and long-term goals. Private sector providers of nuclear power have expressed their priorities, but they are inevitably short term in nature and may not necessarily include long-term, national priorities.

- A sustainable approach to used fuel disposition and waste management. Confidence must exist in the ability to manage nuclear fuel and to dispose of nuclear waste safely so as to enable the sustainable expansion of nuclear energy.

- A clear focus on strengthening the nonproliferation regime. Enhanced safeguards and physical security, international fuel service arrangements, and new nuclear fuel cycle technologies can advance our nonproliferation objectives.

- A mechanism for review by the stakeholders to ensure that the strategy remains relevant to current and future national needs and international conditions.

Rebuilding of the Nuclear Enterprise

The nuclear sector stakeholders must address three key areas: manufacturing base, science and technology infrastructure, and human capital. Expansion of nuclear energy will create stresses on the industrial resources needed to build and operate nuclear power plants. Nuclear power plants require a large forged pressure vessel and head, huge civil works, a myriad of pumps and valves, miles of piping and wiring, and robust process and system controls that must be "N-stamp qualified." To have substantial growth in nuclear energy, more suppliers are needed. The worldwide forging capacity is very limited, and

none of it resides in the United States. This example illustrates one of the many choke points in the supply chain. Transport of material, support for construction, and enrichment of uranium for the fuel supply all must be considered. Moreover, financial institutions need to have confidence that a reliable supply chain exists before they will invest in new plant construction.

The science and technology infrastructure must include modern capabilities such as irradiation systems for testing new fuels and structural materials; chemical separations and characterization capabilities; and physics facilities for radiation transport, thermo-hydraulics, cross-sections, and criticality science. These and other capabilities require modern facilities; however, our current R&D infrastructure, which was built during the Cold War, has atrophied and is obsolete. Modeling and simulation technologies have made tremendous advances since the design of the existing facilities. The design of the next-generation facilities must incorporate state-of-the-art testing and diagnostics tools and be guided by the data requirements for advancing the realism and accuracy of high-performance simulation tools and approaches.

In addition, training the next generation of engineers and scientists must be an integral part of a robust nuclear program. A recent industry study pointed out that over the next five years, half of the nation's nuclear utility workforce will need to be replaced. To satisfy the need for both professional and crafts workers, government and industry must both play important roles to stimulate workforce development for construction, operations, and R&D by providing an environment that is exciting and thriving. Industrial and federal government commitment will be required to invigorate university and trade school programs. For example, the government should establish and fund a nuclear energy workforce development program at universities and colleges to meet the expected need.

Research and Development

To reduce cost, ensure sustainability, and improve efficiency, safety, and security, investments in a sustained nuclear science and technology R&D program are needed. Such a program must effectively support and integrate both basic and applied research and use, to the extent possible, modeling and simulation capabilities to address both near-term, evolutionary activities (e.g., life extensions of the current fleet) and long-term solutions (e.g., advanced reactors and fuel-cycle facilities). Industry will pursue evolutionary R&D to further improve efficiencies along each step of the current fuel cycle. It is incumbent upon the government, however, to implement long-term R&D programs for developing transformational technologies and options for advanced nuclear fuel cycles. Including regulators in the research and evaluation of results will facilitate the development of licensing and regulation of future nuclear facilities and technologies. Review of research plans and results by expert peer reviewers and open availability of the results will strengthen these efforts.

International Engagement

Thirty countries currently operate nuclear power reactors, and approximately thirty-five reactors are under construction outside the U.S. An additional two dozen countries

that have never used nuclear power to generate electricity (e.g., Egypt, Indonesia, Turkey, Vietnam) are now expressing serious interest in the technology, citing stability, security, sustainability, and environmental stewardship as key drivers. As a result, the amount and types of nuclear material in the world will grow, commerce in nuclear technology and materials will increase, and there will be interest in assuring a reliable supply of nuclear fuel. Ongoing bilateral and multilateral engagement will provide opportunities for improving our understanding of the needs, plans, and initiatives of other countries; the potential benefits and risks of these initiatives; and ways to positively impact technological development and choices. The R&D of viable technical options for the United States will also maximize our ability to influence the expanding global commercial enterprise.

CHALLENGES AND OPPORTUNITIES

Important challenges and opportunities are on the horizon: near-term expansion, used nuclear fuel disposition, a sustainable "closed" fuel cycle, and nonproliferation and security. These are discussed below.

Near-term Expansion

An urgent need exists to extend the life of our existing nuclear plants; to begin building new plants, including addressing the financial constraints; and to implement further cost improvements. Relicensing for 60 years has already occurred for many existing reactors and is being aggressively sought for the remaining plants. In parallel, R&D activities that explore the technical feasibility and path forward for long-term operations to 80 years should also be pursued.

Capital investments required for construction of nuclear plants are substantial, and private sector investment decisions must seriously consider risks over a long planning horizon, including the ability to recover capital costs through the rate base. Since new nuclear power deployments are in the national interest, the private sector and government share the responsibility for undertaking the activities needed to ensure that the investment risk associated with constructing, licensing, and operating new light-water reactors is reduced sufficiently to enable commercial investment and deployment. The Energy Policy Act of 2005 provides important loan guarantees, standby support, and tax credits to mitigate financial and regulatory risks that need to be implemented: the financial community and rate regulators must be engaged to enable nuclear energy expansion. Finally, critical support of the NRC for license review and approval also needs to continue to ensure timely review of new license applications.

Further cost-effective technical improvements to light-water reactors are feasible. In addition to simplified reactor and ancillary systems, areas of emphasis include the development of sensing capabilities, robust communication systems, and development of advanced approaches to safeguards and physical protection. The achievement of a simplified safe and secure plant will also require systematic consideration of human factors as a major contributor to a plant's economics, safety, security, and operational performance. Many of these advances can also provide cost-efficient operations and maintenance of existing plants.

Used Nuclear Fuel Disposition

The disposition of used nuclear fuel must be considered from both a short- and long-term perspective. Confidence regarding the disposal of waste is needed before the NRC will grant a license for a new plant and before private investors will accept the financial risk of ordering new nuclear plants. In the short term, this confidence can be achieved by continuing the licensing of a geologic repository at Yucca Mountain and enabling the continued interim storage of used nuclear fuel in dry casks and fuel pools.

Dry cask storage is a safe and secure interim solution, either at existing reactor sites or consolidated regionally if future circumstances dictate. Through policy and investment actions, government can make it clear that interim storage is not intended to push the burden of an ultimate solution to a future generation, but rather to keep waste management options open, pending the results of continued R&D investments. The use of dry casks incorporates proven technologies and regulatory regimes to protect the public from hazards during handling, transport, and storage.

The design and operation of the repository may evolve as knowledge advances. Yucca Mountain Repository was envisioned at a time when the country did not have plans for significant nuclear energy expansion. At that time, used reactor fuel was considered "waste"; thus, direct disposal was chosen as the approach. In the long term, given the envisioned expanded use of nuclear energy, it is both appropriate and timely to reconsider the sustainability of the fuel cycle and to recognize that even with recycling, a geologic repository will be required. In our opinion, R&D must be conducted, and a comprehensive evaluation of disposition pathways must be performed.

Sustainable "Closed" Fuel Cycle

As nuclear energy expands, the traditional once-through fuel cycle will not be sustainable. To maximize the benefits of nuclear energy in an expanding *nuclear energy future*, "closing" the fuel cycle will ultimately be necessary. Simultaneously addressing such issues as the full utilization of the fuel's stored energy content, waste minimization, and strengthening of the nonproliferation regime is essential and will require systems and economic analysis; and investigation of new technologies. Thus, the immediate urgency of our efforts should be directed toward conducting broad-based R&D to support an informed decision on how to proceed. The results of these investments will yield a deeper understanding of the above issues, and will provide the basis and timing for closing the fuel cycle. We believe that the decades-long hiatus in U.S. investment provides an opportunity and an advantage to avoid reliance on a dated recycling infrastructure. As a result, our nation has the opportunity, through new technologies and business models, to determine the best path forward.

An evaluation for light-water reactor recycling in the near-term must consider the increased efficiency in the use of fissile resources, the alteration of waste forms and reductions in overall waste burden, the anticipated need for plutonium/actinides to fuel fast reactors for burning or breeding, and U.S. nonproliferation objectives. Other considerations include establishing a credible U.S. role in an international fuel supply regime, getting our nation back into industrial-scale reprocessing, and demonstrating U.S.

leadership in providing nuclear safety, safeguards and other essential disciplines in the global nuclear renaissance. Integrated analyses of the factors above have not provided sufficient direct evidence to date to support substantial Federal Government investments to deploy existing technology for commercial scale recycling in light-water reactors. It is incumbent upon the Federal Government to establish the policy framework and working with industry ensure that technologies are available for deployment that satisfy that framework, including the non-proliferation and waste management considerations discussed in this paper, while the marketplace will ultimately determine the need for implementation within that framework.

Nonproliferation and Security

Strengthening the nuclear nonproliferation regime in the context of the global expansion of nuclear energy will require a multipronged approach. While the nonproliferation regime and other institutional measures will continue to provide the primary framework to ensure that the growth of nuclear power does not increase proliferation and terrorism risks, there should be a strong emphasis on limiting the spread of enrichment and reprocessing capabilities and enhancing our ability to track, control, and protect nuclear materials.

Three key areas will help to accomplish this focus: an assured fuel cycle service system with incentives for foregoing enrichment and reprocessing capability, improved safeguards technologies and transparency, and "safeguards by design" (i.e., designing safeguards technologies and methodologies into new facilities or systems). These key areas should be tightly integrated with other nuclear fuel cycle R&D and be informed by a risk assessment methodology. This methodology will enhance our ability to understand the benefits and risks of fuel cycle choices in the context of the overall fuel cycle system. These choices include technology options, framework options, and policy options. As an example, formulating international frameworks that support U.S. nonproliferation policy objectives will require understanding the energy goals and objectives of other countries, options for meeting these objectives, and a clear understanding of any specific trade-offs.

COMMITMENT OF THE NATIONAL LABORATORIES

Our nation is facing urgent problems in energy, environment, and national security. Nuclear energy can play a vital role in meeting our future energy needs, reducing our dependence on foreign oil, and protecting our environment. However, a clear national strategy with bipartisan support and strong U.S. leadership is necessary. The national laboratories, working in collaboration with industry, academia, and the international community, are committed to leading and providing the research and technologies required to support the global expansion of nuclear energy.

Statement of Senator Jim Bunning
Budget Committee on Department of Energy's Budget
For Fiscal Year 2010
March 11, 2009

Thank you Mr. Chairman. Welcome Dr. Chu. It is good to see you again.

I think the Department of Energy Budget for Fiscal Year 2010 will be one of the most important in quite a while.

Not only do we have to address funding important energy programs vital to our energy security but we now find ourselves in the midst of a debate on climate change with President Obama's cap and trade revenue program.

I do not believe that the budget process is the appropriate venue for a debate on cap and trade. Legislation so far reaching should be fully vetted and debated in the appropriate committees of jurisdiction – such as the Energy Committee, of which I am a member of.

We can all agree that the future of energy is clean energy. This includes all forms of clean energy such as nuclear and clean coal with carbon sequestration.

At a time when the government is all too quick to step and subsidize industries we must be careful not to let the government pick winners and losers in this debate.

I believe that we should focus on providing industry incentives to lower emissions and spur on technological development.

If we do not and act too rapidly through imposing strict Federal environmental mandates and carbon taxes all Americans will pay the cost through a dramatic increase in utility prices.

If enacted, President Obama's cap and trade revenue program will institute one of the largest tax increases in American history. Moreover, the proposed tax cut it will be used to pay for will benefit few but affect everyone's pocketbooks.

I do not believe in using such budget gimmicks to impose backdoor taxes on the average American family.

Thank you Mr. Chairman and I look forward to questioning our witness.

QUESTION FROM SENATOR MURRAY

Marine and Hydrokinetic Research and Development

Q1. As I mentioned, the Department's only marine sciences laboratory is located in Sequim, Washington and I believe it can be a real asset to the Department in addressing marine energy R&D opportunities.

Before our nation can fully realize the potential of marine energy-as a carbon-free energy source, we must accurately assess our resources, and evaluate new technologies to determine impacts.

- Can I have your assurance that you will engage the Marine Sciences Laboratory as you move this program forward?

A1. The Department of Energy (DOE) is engaging with the Pacific Northwest National Laboratory's (PNNL) Marine Science Lab (MSL) by employing its valuable capabilities in physical oceanography and marine biology related to the development of ocean energy. The MSL is working collaboratively with DOE-supported ocean energy projects, including Snohomish Public Utility District's development of a tidal energy site in the Admiralty Inlet section of the Puget Sound and the Northwest National Marine Renewable Energy Center, a joint Oregon State University-University of Washington program addressing wave and tidal energy R&D and testing.

QUESTION FROM SENATOR MURRAY

Hanford Site Cleanup

Q2. Mr. Secretary, I like the 2015 vision for the Hanford Site and am certainly dedicated to cleaning up along the River Corridor at Hanford but I'm concerned about keeping the cleanup momentum going after 2015. There is a tremendous amount of work to be done in the Central Plateau and it will be more difficult and technologically challenging in many cases. Will you commit to fulfilling the government's responsibility to cleanup the Hanford Site by maintaining the Hanford budget post-2015 to allow for full scale cleanup of the Central Plateau for the citizens of Washington?

A2. The Office of Environmental Management is committed to continuing the cleanup activities post-2015 at the Hanford Site. The Hanford Site continues to be a top priority for the Department with projected expenditures exceeding $50 billion and cleanup activities continuing through FY 2062. The Department will be assessing the full impact of American Recovery and Reinvestment Act funding on those projections and how to best capitalize on the momentum gained from those investments.

QUESTION FROM SENATOR NELSON

Q1. Secretary Chu, there have been many criticisms regarding the Department's loan guarantee program. I know you have made important changes in the past month to streamline the program, which you said "required too much paperwork, require prohibitive upfront costs and it simply took too long."

Can you detail the changes you've made and outline how they address the problems that have prevented the program from disbursing any funds in four years?

A1. We have accelerated the loan guarantee process significantly while maintaining appropriate evaluation and due diligence to protect taxpayer interests. We are shortening the cycle time from application to loan guarantee to ensure good projects quick funded quickly. The changes include streamlining paperwork requirements and providing additional resources to process applications and working with industry to attract good projects while helping them navigate the process. And, in fact, the Department offered its first loan guarantee on March 20, 2009 to Solyndra, Inc., a California company which will construct a commercial-scale manufacturing plant for its proprietary cylindrical solar photovoltaic panels.

QUESTION FROM SENATOR NELSON

Q2. Others before you from the Energy Department have appeared before Congress and testified that fixing the loan guarantee program was a top priority, but nothing happened. While you have clearly made major changes already, is there more that you'll need to do to fix this troubled program?

A2. The Department recognizes the urgency in the current economic environment to move quickly in implementing the Loan Guarantee Program, while protecting taxpayer interests. Specifically, we have commenced an effort to accelerate our ability to issue loan guarantees by shortening the cycle time from application to loan guarantee while still ensuring that good projects get funded quickly. I am closely reviewing the program and working to ensure that the Department has the right team and processes in place to accelerate issuing loans. And, in fact, the Department offered its first loan guarantee on March 20, 2009 to Solyndra, Inc., a California company which will construct a commercial-scale manufacturing plant for its proprietary cylindrical solar photovoltaic panels.

QUESTION FROM SENATOR CRAPO

Yucca Mountain

Q1. Secretary Chu, in the executive order lifting the ban on federal funding of stem cell research, President Obama signed a memo directing federal agencies to keep politics out of federal scientific activity. Numerous National Academy of Science panels have recommended deep geologic disposal of high level waste and used nuclear fuel and even the report that you signed called for the development of Yucca Mountain as a long term resource.

Can you tell me that science and not politics was the basis for your decision to end the effort to develop the Yucca Mountain nuclear waste repository?

A1. President Obama has made it clear that Yucca Mountain is not a workable option. This decision is not based on a determination that a repository at the Yucca Mountain site could not meet regulatory requirements but rather reflects the Administration's belief that science can find a better solution that achieves a broader national consensus. To that end, the Administration intends to convene a "blue-ribbon" panel of experts to evaluate alternative approaches for meeting the federal responsibility to manage and ultimately dispose of spent nuclear fuel and high-level radioactive waste. This panel will provide the opportunity for a meaningful dialogue on how best to address this challenging issue and provide recommendations that will form the basis for working with Congress to revise the statutory framework for managing and disposing of spent nuclear fuel and high-level radioactive waste. Until however the statutory framework is revised, the Department will continue to participate in the ongoing licensing proceeding at the Nuclear Regulatory Commission (NRC) on the license application for a repository at Yucca Mountain and respond to questions from the NRC so that NRC can fulfill its statutory obligation to issue a final decision approving or disapproving

the issuance of construction authorization for the repository within three years. The Department, however, is not spending money on any further development of the Yucca Mountain repository and related infrastructure.

QUESTION FROM SENATOR CRAPO

Yucca Mountain

Q2. There is no other disposal option for the type of defense waste currently located in Idaho, Washington State, and South Carolina, but to permanently dispose of it in a deep geologic repository like Yucca Mountain. I support looking at other management options for commercial used nuclear fuel. Would you considering disposal of the defense waste ONLY in Yucca Mountain? If not, how do you propose to find another permanent disposal site?

A2. As I have stated, the Administration intends to convene a "blue-ribbon" panel of experts to evaluate alternative approaches for meeting the federal responsibility to manage and ultimately dispose of spent nuclear fuel and high-level radioactive waste. The blue ribbon panel will consider options for both defense waste and commercial spent nuclear fuel. In so doing it will take into account the unique characteristics of defense wastes and national security issues. This panel will provide the opportunity for a meaningful dialogue on how best to address this challenging issue and provide recommendations that will form the basis for working with Congress to revise the statutory framework for managing and disposing of spent nuclear fuel and high-level radioactive waste from both commercial and defense activities.

QUESTION FROM SENATOR BUNNING

Q1. Renewable Portfolio Standard - Research has shown that a new coal gasification plant with carbon dioxide capture can produce power for 10 cents per kilowatt hour. It can also be placed at a location much closer to where the power is consumed as opposed to other renewable sources. If that is the case, does it not make sense to include coal fired generation with carbon capture and storage capability as a qualified energy source in an RPS bill?

A1. While the Department of Energy supports carbon capture and sequestration, coal is a finite resource, and electricity generation from this fuel by conventional technology should not be considered a qualified energy source in a Renewable Portfolio Standard bill.

QUESTION FROM SENATOR BUNNING

Q2. Nuclear – If the goal of the Administration's cap and trade budget proposal is to reduce emissions, will you support making nuclear a component of your clean energy proposals? Not only do nuclear power plants emit zero emissions but the construction of a new nuclear power plant could create up to 1,800 jobs. Will you support bringing any new nuclear reactors online?

A2. Nuclear power currently supplies nearly 20 percent of the Nation's electricity and approximately 70 percent of its greenhouse gas-free electricity. It is unlikely that the U.S. can meet its aggressive climate goals if nuclear power is eliminated as an option, but as industry moves forward with expansion, the federal government must continue to address the key issues of security of nuclear fuel and waste, waste storage, and proliferation.

QUESTION FROM SENATOR BUNNING

Q3. Yucca – In the President's Budget request, he dramatically scales back funding for the Yucca Mountain Nuclear Waste site further jeopardizing DOE's obligation to take possession of nuclear waste. You have stated that you have an alternative plan for Yucca Mountain. What is this plan? What is your timeline to institute this plan?

A3. I have stated previously that the Administration intends to establish a blue ribbon panel of experts to evaluate alternative approaches for meeting the federal responsibility to manage and ultimately dispose of spent nuclear fuel and high-level radioactive waste. This panel will provide the opportunity for a meaningful dialogue on how best to address this challenging issue and provide recommendations that will form the basis for working with Congress to revise the statutory framework for managing and disposing of spent nuclear fuel and high-level radioactive waste.

QUESTION FROM SENATOR BUNNING

Q4. Coal-to-Liquid Fuels – I know that you are concerned with coal-to-liquid fuel because of environmental issues. Research has shown that using a combination of commercially available carbon capture technology and biomass blending will reduce the carbon footprint of coal-to-liquids well below conventional fuels. Are you aware of this environmental potential for coal and biomass gasification? If so, is this something that you would be willing to support funding for along with other biofuels?

A4. We are aware of the environmental potential of alternate fuel production systems that utilize mixtures of coal and biomass as a gasification feedstock. The Department supports research and development of technology for hydrogen from coal and coal and biomass gasification processes in the Office of Fossil Energy.

QUESTION FROM SENATOR BUNNING

Q5. Smart Grid and Cyber Security - What does Smart Grid technology promise in terms of reliability? A smart grid is supposed to increase our system's security but technology like smart meters and advanced communication networks can actually increase the vulnerability of our grid to cyber attacks. How do you plan to address these cyber security concerns? Do the agencies have sufficient authority or is additional federal legislation needed?

A5. The Smart Grid offers a number of opportunities to improve grid reliability. For example, through the use of AMI (advanced metering infrastructure) with two-way communications at the distribution level, utilities can remotely identify, locate, isolate, and restore power outages more quickly without having to send field crews on trouble calls. At the transmission level, phasor measurement units synchronized with global-position systems can provide enhanced situational awareness across wide areas of the power grid to detect and deter grid disturbances much faster than existing systems. In addition, the Smart Grid will enable greater use of distributed resources and technologies to control load to enhance reliability.

The Department has been working with the private sector for several years to enhance cyber security in the energy sector through the implementation of the *Roadmap to Secure Control Systems in the Energy Sector*. The Department has conducted cyber security assessments of more than 20 supervisory control and data acquisition (SCADA) systems, which represents over 90 percent of the current market offering in the electricity sector. As a result, vendors have developed next-generation "hardened" systems that are now being deployed in the market. In addition, the Department is partnering with the AMI Security Task

Force organized under the UCA International User's Group to develop cyber security requirements for AMI – a foundational smart grid application. The Task Force is comprised of utilities, security domain experts, standards body representatives and industry vendors. On March 10, 2009, the Task Force published the *AMI System Security Requirements*, which provides critical guidance for vendors and utilities to help design and procure secure and reliable AMI systems. The Task Force will also produce a vendor catalog of smart meters, an implementation guide, and procurement guidelines. Because of the success of this industry-government partnership, the Department is expanding the scope of the project to develop comprehensive cyber security specifications (including penetration testing) for all critical Smart Grid applications.

At this time, we do not foresee the need for additional Federal legislation to accomplish our goal through public-private partnerships. The Department will continue to work with the National Institute of Standards and Technology to accelerate the development of a framework for the complete suite of interoperability standards. Once a standard is completed by the applicable standards development organization, the Federal Energy Regulatory Commission will issue a rulemaking to adopt the standard as required under the Energy Independence and Security Act of 2007.

QUESTION FROM SENATOR BUNNING

Q6. Smart Grid Technology - In remarks at the National Clean Energy Project summit, you stated that the failure to agree on standards and protocols to allow different systems to communicate with each other is the "biggest bottleneck" for Smart Grid technology. You have suggested in the past that we should lock people up in a room and tell them to come out with a standard in a few weeks. What is a realistic time frame to develop a communications network for Smart Grid? Is it really just as simple as locking folks in a room for a couple of weeks?

A. The pace of smart grid standards development is being accelerated to facilitate integration and reduce life cycle costs in the early stages of smart grid project deployments. Stakeholders are being brought together to identify gaps and shortcomings in existing standards that are needed for high value, near-term, smart grid deployment. At this time, the Department believes there is sufficient effort underway to develop cyber security safeguards and interoperability standards to begin smart grid deployments without delay. The Department is proceeding with implementing smart grid deployments and standards development in parallel.

QUESTION FROM SENATOR ENSIGN

Q1. If the Yucca Mountain project is dead, and I think we both agree that it is, how much time do we have before we need a permanent solution to nuclear waste? In broad terms, what form do you see a permanent solution taking?

A1. The Nuclear Regulatory Commission has determined that spent nuclear fuel can be stored safely at reactor sites for up to 100 years. I believe that considerably less time will be needed to implement a permanent solution. As I have stated previously the Administration intends to establish a "blue ribbon' panel of experts to evaluate alternative approaches for meeting the federal responsibility to manage and ultimately dispose of spent nuclear fuel and high-level radioactive waste. This panel will provide the opportunity for a meaningful dialogue on how best to address this challenging issue and provide recommendations that will form the basis for working with Congress to revise the statutory framework for managing and disposing of spent nuclear fuel and high-level radioactive waste from both commercial and defense activities.

QUESTION FROM SENATOR ENSIGN

Q2. We both support nuclear energy but oppose Yucca Mountain. Do you think forming a commission to explore alternatives to Yucca and new solutions for our nuclear waste problem will help the nuclear energy industry in the long run? Do you have any recommendations as to some of the issues the commission should examine in terms of nuclear waste alternatives?

A2. Yes, I do think forming a "blue ribbon" panel of experts, or commission, to explore alternatives to Yucca Mountain and new solutions for our nuclear waste problem will help the nuclear energy industry in the long run. I have mentioned previously that an expert panel, or commission, should examine all the possible alternatives, including alternative repository sites, interim storage, on-site storage, and exploring new technologies for the disposal of spent nuclear fuel and high-level radioactive waste.

QUESTION FROM SENATOR GRAHAM

Q1. Secretary Chu, South Carolina has 7 nuclear plants and the Savannah River Site which stores substantial quantities of DOE defense waste as well as foreign research reactor spent fuel. If Yucca is no longer an option, when will this nuclear material begin leaving the state? Additionally, there is currently at least 12,800 metric tons of defense related high-level waste and spent nuclear fuel slated to be shipped to Yucca Mountain. Do you envision a scenario in which we open Yucca Mountain only to defense waste?

A1. President Obama has made it clear that he believes Yucca Mountain is not a workable option. The Administration plans to convene a "blue-ribbon" panel of experts to evaluate alternative approaches for meeting the federal responsibility to manage and ultimately dispose of spent nuclear fuel and high-level radioactive waste. This panel will provide the opportunity for a meaningful dialogue on how best to address this challenging issue and provide recommendations that will form the basis for working with Congress to revise the statutory framework for managing and disposing of spent nuclear fuel and high-level radioactive waste. These experts will evaluate alternative approaches for the government to meet its obligation to dispose of the country's commercial and defense spent nuclear fuel and high-level waste. Although at this time I cannot provide a time frame for when the defense nuclear material from South Carolina will begin leaving the state, I can assure you that the material will be safely managed as long as it remains in South Carolina.

QUESTION FROM SENATOR GRAHAM

Q2. The Loan Guarantee Program is considered a critical component to encouraging the development of the first few nuclear power plants in the United States. At present that program does not work for generating units that are co-owned in public-private partnerships because of cross-collateralization requirements. I understand that ranking of the current applications pending at the Office of Loan Guarantee includes three public-private partnerships in the top five applications. These projects are in jeopardy if there is not a fix to this program. What efforts are you taking to fix the problems with the program to allow public-private ventures to access it?

A2. DOE is committed to review all issues associated with the proposed ownership structures on a case-by-case basis. The information provided in the Part II Nuclear Power Facilities applications received on December 19, 2008, forms the basis for this review.

QUESTION FROM SENATOR GRAHAM

Q3. Last week, you testified in the Senate Energy Committee that solidifying spent nuclear fuel was an alternative to Yucca Mountain. Can you expand on your statement? Does this mean that you see spent nuclear fuel as waste? If you solidify the spent fuel, doesn't it still ultimately have to be disposed of somewhere? Once spent nuclear fuel is solidified, is the potential energy remaining in a fuel rod retrievable?

A3. Spent nuclear fuel can be placed in wet or dry storage without changing the solid form in which it taken out of the reactor. I believe one of the options that deserves serious consideration is to continue development of advanced technologies to reprocess the spent nuclear fuel to remove and recycle useful components of the spent nuclear fuel and then to dispose of the remaining radioactive material.

QUESTION FROM SENATOR GRAHAM

Q4. The Savannah River National Laboratory is the Department of Energy's newest national laboratory. Despite this, SRNL is the national lab most in need of infrastructure improvements. Will you approve stimulus money to improve infrastructure at the national laboratories? How do you plan to capitalize on SRNL so it can reach its full potential?

A4. The Office of Environmental Management (EM) is developing a plan to use Recovery Act funds to support cleanup in the areas of solid waste disposition, deactivation and decommissioning of structures, as well as soil and groundwater remediation. These are areas where the EM program has generally demonstrated technical and management success so we do not anticipate that Savannah River National Laboratory (SRNL) support will be needed to achieve this cleanup.

The SRNL is funded indirectly in support of programmatic activities carried out at the Savannah River site. The site continues to be a priority for the Department with projected expenditures exceeding $40 billion and cleanup activities continuing through fiscal year 2040. To the extent SRNL support is needed to complete cleanup of this site, the necessary coordination will occur.

QUESTION FROM SENATOR GRAHAM

Q5. The Omnibus Appropriations Act passed yesterday included report language directing DOE to provide a comprehensive lifecycle cost estimate for continuing operations of H-canyon. Will this study also include the increased costs and additional time closing H-Canyon will add to the cleanup schedule at SRS? Do you know these costs?

A5. As directed by the House language, the Department of Energy will provide a comprehensive lifecycle cost estimate for the continuing operations of H-Canyon that includes all waste disposal and contingency costs for nuclear material that will be included in the Department's H-Canyon processing plans. This comprehensive lifecycle cost estimate will include costs for operating the facility and for its subsequent deactivation, which consists of placing the facility in a low risk and safe shutdown condition that is economical to monitor and maintain for an extended period, until the eventual decommissioning of the facility. We will provide cost estimates, including the costs for decommissioning and ultimate disposition, when this analysis is complete.

QUESTION FROM SENATOR GRAHAM

Q6. What is your interpretation of the 2001 Defense Authorization language requiring H-Canyon "maintain a high state of readiness?"

A6. H-Canyon is currently being operated to process surplus highly enriched uranium materials. However, if the facility is not actively processing nuclear materials or spent nuclear fuels, we interpret that specific language to mean that the facility should be physically maintained, and that the staff maintain their qualifications, such that the facility is capable of being operated.

THE PRESIDENT'S FISCAL YEAR 2010 BUDGET AND REVENUE PROPOSALS

THURSDAY, MARCH 12, 2009

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

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

Present: Senators Conrad, Murray, Wyden, Feingold, Nelson, Stabenow, Cardin, Sanders, Whitehouse, Warner, Merkley, Gregg, Sessions, Bunning, Crapo, Graham, and Alexander.

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

OPENING STATEMENT OF CHAIRMAN CONRAD

Chairman CONRAD. The Committee will come to order.

I would like to welcome the Secretary of the Treasury, Tim Geithner, here this morning. Good to have him back before the Budget Committee. Today's hearing will focus on the President's budget and revenue proposals. I have described the President's budget as a "good beginning." The key priorities of the budget focusing on reforming health care, excellence in education, and reducing our dependence on foreign energy I believe are the right priorities. I also think it is critically important to be cutting this deficit dramatically over the first 5 years. We all understand we have inherited a very serious economic situation that requires an extraordinary response, and that means increased deficits and debt in the short term. But I think it is also critically important that we recognize over the longer term we are on an unsustainable course, and it is absolutely essential that we return to a more fiscally prudent path in the future.

I want to say what I have said before, that while I think the President's budget is a good beginning, especially over the first 5 years, I am very concerned about the second 5 years. I have said this directly to the President. I have said it to every representative of the President that has come to see me. I am very concerned about the second 5 years.

We know that the President has been handed an extraordinary set of crises.

What President Obama Is Inheriting

- Record deficits, doubling of national debt
- Worst recession since Great Depression
- Financial market and housing crises
- 3.3 million jobs lost in last six months
- Ongoing wars in Iraq and Afghanistan

I have thought often what it must be like to be President of the United States at this time to face a housing crisis, a fiscal crisis, a banking crisis, on top of that an overall economic crisis, with the explosion of joblessness in this country, the worst conditions since the Great Depression, and in the midst of it all, two wars.

The President's budget includes, I believe, a number of key improvements.

Obama Budget Has Key Improvements Over Bush Budgets

- More transparency, accounts for war costs
- Better priorities – key investments in energy, education, health care
- Cuts deficit in half

I certainly salute his transparency, putting on the table things we know are going to be expenditures but in the past have been left out. I also very much agree with the fundamental priorities on education, energy, and health care, and cutting the deficit in half over the first 5 years.

Revenue Changes in Obama Budget

Extend 2001 and 2003 tax cuts for those under $250,000	-$2.0 T
Making Work Pay / other provisions for individuals, businesses	-$940 B
AMT relief	-$576 B
Cap and Trade	$646 B
Loophole closures, international reforms	$353 B
Limit itemized deductions (not in budget totals)	$318 B
Total Tax Cuts	-$2.2 T

Source: OMB
Note: Revenue totals include outlays associated with refundable tax provisions.

On the issue of taxes, some critics of the President's plan argue it represents a tax increase, and for some clearly it does. That is accurate. On an overall basis, I see something quite different, and I think CBO—and they will score this budget—will also conclude something quite different, because under the traditional scoring rules that we use around here, this budget represents over a $2 trillion tax reduction.

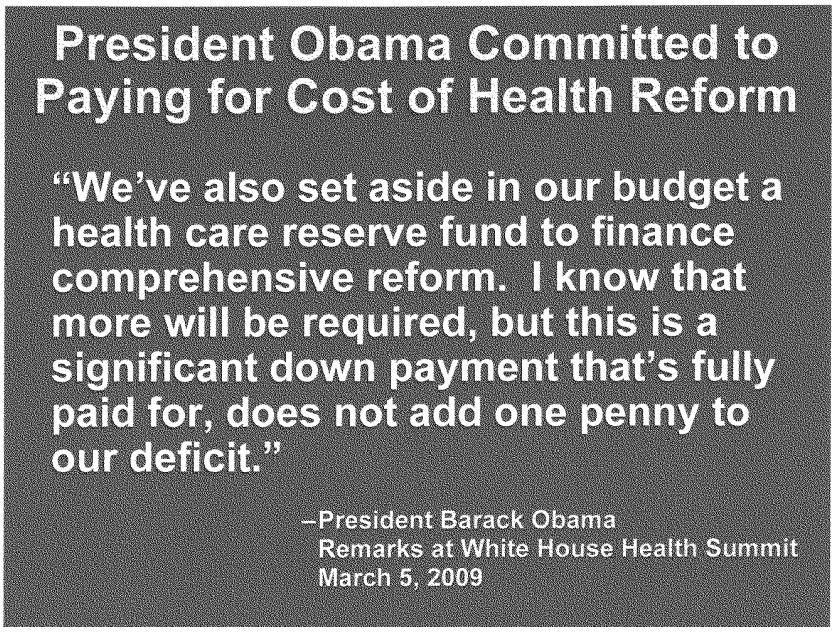
How do I get there? Well, this budget extends the 2001 and 2003 tax cuts for everybody earning below $250,000 a year. That is a very significant tax reduction from what current law provides.

No. 2, this budget extends the alternative minimum tax so that it does not affect 20 or 25 million taxpayers that would otherwise be affected. And that, too, is not contemplated under current law. That represents a very dramatic tax reduction.

In the estate tax, the extension of the provisions at $3.5 million exemption, current law would take it back to $1 million. That represents significant tax reduction.

And I could go on and on, but I will not. My colleagues know what is in this budget. The President's budget also contains the Making Work Pay tax cuts and other provisions for individuals and businesses.

When you net it all out—and I include the provisions on climate change, because while that is not strictly considered a tax, nonetheless it has the same effect economically. And so if you wrap that up as a tax increase and you net it all out, this budget has $2.2 trillion of tax reduction, and I believe that will be the CBO scoring.

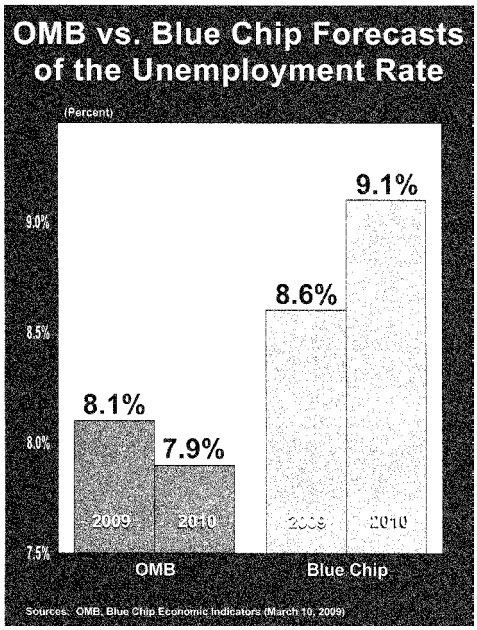


I would like to particularly commend the President for committing to pay for the cost of health care reform. This is an area that gives many of us great pause, because we are already spending one

in every $6 in this economy in health care. We have had testimony before this Committee that as much as 30 percent of that is being wasted. When we have got a circumstance in which the UCLA Medical Center's costs are 100 percent more than the costs of the Mayo Clinic health care system, we know there is room for dramatic savings and still have quality health care outcomes, because the Mayo results are actually better than the UCLA results, even though they cost half as much.

Now, we see that across the country. So some of us have real pause about the notion of putting substantially more money into the health care system when we have already got a bloated system.

What I am most concerned about, as I said at the beginning, is the debt outlook for the Nation.



In the previous administration, we saw the debt more than double from $5.8 trillion to $12.7 trillion this year. I have never held the President, the previous President or this one, responsible for their first year; they are inheriting a situation. But when I look at this budget, I see the debt doubling again, and that gives me great concern. Again, based on testimony before this Committee, Democratic witnesses, Republican witnesses, some of the finest economic minds in this country and, indeed, the world, coming before this Committee day after day after day warning us of the danger of a buildup of debt. And I believe it. I want to make very clear I believe that build-up of debt fundamentally threatens the economic security of this country. I believe it in my bones.

Now, maybe part of that is I am Danish. I find that Steny Hoyer over in the House—he is Danish, too—seems to have the same views. I looked at the Danish debt-to-GDP ratio and see it is the

lowest, so maybe I come by this honestly. Maybe it is genetic. But I must say I am concerned about it. Excuse me?

Senator GREGG. Can you skate?

Chairman CONRAD. Oh, yes, I can skate. I'm a North Dakota boy.

So I want to emphasize I feel it is critically important we do better in the second 5 years. We need to keep in mind what is at stake here. We are on, as a Nation, an unsustainable fiscal course. That is not the fault of this administration. It is not the fault of this administration. But we are inheriting a situation that we have to grapple with and we have to address. And as I say, I think the President has done a very commendable job in laying out the first 5 years. I am much more concerned about the second 5 years.

Now I will turn to Senator Gregg. One other thing I should mention, and that is, I also believe that the first TARP, as imperfect as it was—and I believe it was very imperfect. I believe had we not done the first TARP that we would have faced an economic collapse. Senator Gregg and I were in the room as the reports were delivered to us that night. We were there all night. We heard the reports of financial institutions going down all across Europe. We heard the reports very directly of major enterprises in America that were on the brink of going down. There is no question in my mind that if we had not done the first TARP, we would have faced an outright economic collapse.

With that said, was it done as best as it could have been done? No. And, unfortunately, we are living with the results of that now, deep anger in our constituencies. And let me just say anybody that does not understand the anger of the American people is not paying very close attention.

Every day I get the letters that come to me from my constituents, and the anger level is extraordinary. I have never—in the 22 years I have been here, I have never seen such anger with the sense of betrayal that people in positions of responsibility took advantage of them, and they, no fault of their own, now are getting stuck paying part of the bill. The outrage of people cannot be dismissed.

Senator GREGG.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman, and let me pick up there, because I want to praise the Secretary. I recognize he has come in for a fair amount of constructive thought since he had become Secretary. But I want to praise his efforts and the commitment of this administration under the Secretary, as well as Larry Summers and Chairman Volcker, to try and stabilize the financial institutions of this country. It is very obvious that unless we stabilize the financial institutions of this country, we cannot recover. And as we recover, if we do not have a robust and functioning financial system, the recovery will be stunted.

We all recognize that not everything you have tried has worked. Not everything that Secretary Paulson tried worked. But you are trying, and you are pulling the levers, along with Chairman Bernanke, to try to settle out the financial structure of this country. And I have my specific disagreements with some of your initiatives, and I have my specific agreements.

I agree with many who feel that we should have more aggressively and more actively focused on the underlying problem, which was real estate. And I still do not think we have done it adequately. But the fact is that the initiatives, such as TARP, TALF, and the mortgage initiatives, are putting some meat on the bone right now relative to how you are going to orchestrate getting the private sector to come in and take bad debt off the books of some of these institutions. I think on balance those initiatives have been more than constructive. I hope it is true that our most problematic financial institution has actually made money in the first 2 monthsof calendar 2009—I have not looked at the books, and I do not know how they have accounted for that. But if that is true, that is good news, and maybe we have begun to turn a corner, although there is still a tremendous way to go. So I want to thank the Secretary for his energy in this area. I do hope there are more specifics to come, however.

Now, on the budget I cannot praise you, and, in fact, I pick up again where the Chairman left off, which is that this budget, as it is presently constructed, passes on to our children a Nation which they will not be able to afford and which will potentially drive this country into bankruptcy.

I recognize the fact, because it is obvious, that in the short term there is a need for the Government to step in with huge amounts of money because the Government is the last source of liquidity and, therefore, the spending that is occurring in the short run is necessary. We do not want to do it, but we are going to have to. But some of it has been very unfocused and not all that constructive, such as the stimulus bill.

But after 2 or 3 years, this budget should propose to get spending under control, and it does not. It is proposing a public debt-to-GDP ratio of 67 percent for the next 10 years starting in 2013. Before that, it is higher. It is proposing deficits of 3 to 4 percent post-2013 to the end of the budget period. It proposes expanding the size of the Government as a percentage of gross national product up to 23 percent from its historical average of about 20 percent.

The practical implications of this are that we are essentially putting on our children's backs a debt which they can never get out from underneath and a debt which involves a radical expansion of the size of the Federal Government as a percentage of our economy. And as a result, I think we are putting at risk not only our children's future; we are clearly putting at risk the value of the dollar and our ability to sell debt. Because if I am in the international marketplace and I am looking at this budget, I am saying to myself, "Where is the discipline? Where is the containment?" There isn't any.

Why would I invest in the debt of this country? I know that in the out-years they have got a budget which has no fiscal discipline. And there are only two ways out of that. One is inflation, which is not acceptable. And the other is massive increases in the tax burden, which will significantly reduce the productivity of the economy and as a result undermine the quality of life of everyone in this country.

And so this is a budget which has fundamental flaws. The argument that it cuts the deficit in half in 4 years is truly spurious, be-

cause when you take the deficit and quadruple it and then you cut it in half, that is like taking four steps back and two steps forward. You are not making any progress. You are still going backward.

The argument that this budget does not have tax increases is, I think, an Alice in Wonderland view of the budget because of the baseline they use. The budget proposes raising the effective tax rate from 35 percent to 41, 42 percent. You are severely scaling back itemized deductions on things like mortgage interest and on charitable contributions. The small businesses of this country that are going to be hit with this tax increase. Those are the people who go out there and take the risk, create the jobs. Those are the people that that tax burden is going to fall on mostly. Sure, it will fall on the wealthy, but the large percentage of it is going to fall on people who run sole proprietorships, that little grocery store, the little restaurant, the small software company. They are not going to be able to expand because their tax burden is going to eat up their expansion dollars. They are not going to be able to create jobs.

And then you have got this carbon tax, which is represented as being $646 billion of new revenue. That is a huge amount of revenue, but it is a gross understatement. Every independent group that has looked at this—beginning with MIT, which is the most objective, and CBO—has said that this carbon tax in its form as proposed represents a $300-billion-a-year increase in revenues. That is a massive sales tax, a national sales tax, on everybody's electric bill, especially people from the Midwest and the Northeast.

And what do you do with that revenue? You do not use it to reduce the deficit. You use it to expand the size of Government.

There is a representation that a part, 80 percent, of the first $64 billion is going to go pay for the Make Work Pay tax credit, but the remaining 20 percent goes to raise the size of the Government. And then on top of that, you are going to get another $200 billion, potentially, and there is no representation that that is coming back to taxpayers. In fact, there is specific language which makes it pretty clear that that is going to be used as walking-around money for various constituencies who are interested in spending it. They may be worthwhile constituencies, but it is a heck of a tax burden to put on the American people, and it represents a massive expansion in the size of Government.

I guess that is my big problem here. I join with the Chairman in being concerned about the effects of this budget on our children, because what this budget is passing on to our children is a debt that is not sustainable, a deficit that is not sustainable, and a Government which has grown too fast, too far, and which is not sustainable.

So I am going to be interested to hear your thoughts on that, Mr. Secretary. Thank you very much.

Chairman CONRAD. Welcome. You know, there is nothing quite like it, is there? But this is a debate that we owe the American people.

Secretary GEITHNER. We do.

Chairman CONRAD. And you said it very clearly as you came in. This is a debate we need to have. So we are delighted that you are here, Mr. Secretary. We very much appreciate the extraordinary responsibilities that are on your shoulders and the effort that you

have extended to address the multiple crises facing the country. Please proceed.

STATEMENT OF HONORABLE TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Thank you, Mr. Chairman—and Happy Birthday—Ranking Member Gregg, and members of the Committee. It is a privilege to be here today. As I said coming in, this is an important debate to have. We need to do this openly and honestly for the American people, and I look forward to our conversation.

I just want to briefly summarize my written statement, and I look forward to having a chance to respond to the concerns you both raised in your opening statements. But let me just start with where we are today.

We start, the administration just 7 weeks old, with an economy that has been in a recession for over a year, an intensifying housing crisis, and a financial system under stress. Now, since the recession began 4.4 million Americans have lost their jobs; millions have lost or at risk of losing their homes, or are struggling to obtain loans to finance the purchase of a care, a house, or their kids' education; businesses are finding it harder to get credit; the fourth quarter GDP numbers show our economy declining at the annual rate of 6.2 percent. What you are seeing here you are now seeing around the world, and that is being reflected in greater pressure on our financial system, again, both here and around the world.

Now, the obligation we share is to make sure that our Government does as much as we can to get Americans back to work, to help stimulate private investment, and to help get credit flowing again. We have to move together to try to do this as rapidly and effectively as possible.

Now, as this Committee knows, this crisis has helped cause a dramatic deterioration in our fiscal position. Again, we start this Congress and this administration with a $1.3 trillion budget deficit, the largest deficit as a share of GDP the Nation has faced since the end of the Second World War. These are extraordinary challenges, and these challenges require extraordinary actions.

Now, in passing the Recovery and Reinvestment Act, the administration and the Congress have put in place a very powerful mix of programs to help get Americans back to work and to support private investment. The combined effect of these investments and tax measures will be to save or create save or create between 3 and 4 million jobs and to increase real GDP growth by 3.2 percentage points by the end of 2010 relative to what would have occurred in the absence of this package.

Now, alongside the Recovery Act, the administration is moving to repair our financial system so that it can provide the credit necessary for businesses across the country to expand and for families to finance critical needs.

The deepening recession is putting greater pressure on banks, and in response, many banks are pulling back on credit. And right now, as a result, critical parts of our financial system are damaged and are working against recover. This is a very dangerous dynamic, and to arrest it, we need to make sure our financial system has the

resources necessary to get credit to the economy, and we need to act to get the broader credit markets working again.

Now, to address this financial crisis, we have launched a very powerful program to help jump-start lending to small businesses, student loan markets, consumer credit markets, auto finance markets. This joint Treasury-Federal Reserve program goes around the banking system to try and get the securities markets working again.

We have initiated a forward-looking assessment of the potential capital needs of our major financial institutions, and we have outlined the very detailed terms of a capital assistance program that will provide a backstop for these institutions so that they can raise the capital necessary to support economic recovery.

Now, alongside these initiatives, we will outline an innovative program that uses market mechanisms to help clean the legacy assets on bank balance sheets. This program will be designed to bring in private capital alongside Government financing to help restart markets for these assets.

Now, as we go through this process, as the President has said, we will bring the full force of the Federal Government to ensure that the major banks which Americans depend on have enough confidence and enough resources to lend even in more difficult times. And when these institutions require exceptional assistance, we will hold accountable those responsible, force the necessary adjustments, provide the support to clean up their balance sheets, and assure the continuity of a strong, viable institution that can serve our people and our economy.

All of these actions are necessary to lay the foundation for recovery, and the President's budget builds on this foundation to set us on a path toward long-term growth and a path where we are again as a country living within our means.

The first step in addressing these problems is to be honest about them, and the President's budget honestly and transparently presents the fiscal challenges facing the American people. We include, as you know, the cost of fixing the AMT each year; reimbursements for Medicare physicians; the likely future costs of foreign wars and natural disasters; and in an abundance of caution and realism, the potential need for additional financial crisis funding.

We offer a 10-year rather than a 5-year budget presentation. The budget proposes to carefully but substantially address the most critical challenges facing our economy in health care, in energy, and in education—again, within a framework that puts us on a path to fiscal responsibility and fiscal sustainability.

On the tax side, the budget rewards work, encourages savings, and promotes growth. Important provisions include the Making Work Pay tax credit for 95 percent of working Americans, the expansion of the earned income tax credit, a zero capital gains tax provision for small businesses, and a permanent extension of the R&E tax credit.

Now, receipts in the President's budget average about 18.7 percent of GDP over the 10-year budget window, just slightly above the 40-year historic average, returning us to the same taxation rates that applied during the economic prosperity of the late 1990's.

The budget addresses the tax gap by tackling tax shelters and other efforts that permit abuse of our tax laws. Over the next several months, the President will propose a very substantial package of legislative and enforcement measures to reduce tax avoidance.

I want to emphasize again that we propose no new revenue increases in our budget—none—until we are safely into recovery in 2011. And at that point, when the consensus of private forecasts projects significantly positive growth for the overall economy, the budget restores tax rates to the pre-2001 tax levels for families making more than a quarter of a million dollars.

The soaring cost of health care is hurting families, businesses, and our long-term budget prospects. There is no path—there is no path to addressing our long-term entitlement challenges that does not require major health care reform. And our budget begins this process by reducing cost and inefficiencies, increasing quality and prevention, and moving toward affordable coverage for all.

Just to cite one example—and there are many—the Hospital Quality Improvement Program proposes to pay for performance and reimburse hospitals for the quality of their care rather than merely for the quantity of the services they provide. Health care reform is a moral imperative, an economic imperative, and a fiscal imperative for our Nation.

The budget makes a significant commitment to our energy security that will strengthen our economy, our environment, and our national security. Investments in renewable energy and energy efficiency will create new American jobs and industries and lead the way to a new green economy.

And if we are truly committed to making our Nation both more prosperous and more just, we must recognize that it defies both our basic values and economic common sense to deny any child in America the quality education they need to compete in the global economy. And this budget calls for more resources for early childhood education, new incentives for teacher performance, and a significant increase in the Pell grant, together with President Obama's American Opportunity tax credit, which provides up to $10,000 of tax relief for a single student going to 4 years of college.

Now, I want to emphasize this. Even with these critical long-term investments, the President's budget keeps overall non-defense discretionary spending well below its long-term average as a share of the economy. I want to emphasize this point. Under the President's budget, non-defense discretionary spending would average 3.6 percent of GDP over the next decade, and by the end of the budget window, we propose to bring it down to 3.1 percent of GDP, the lowest level since the 1960's. Overall outlays return to historical norms once you account for the interest costs associated with higher deficits and the impact of the baby-boom retirement on entitlement costs.

So just let me say this again. Once you take out the interest costs associated with the inherited deficits and the cost of fixing this crisis, and you account for the costs of demographic change, aging of the baby-boom generation on entitlement costs, overall outlays return to historical norms. A critically important point.

The President and I share a commitment to working with the Budget Committee to put our Nation back on a path to fiscal sus-

tainability once recovery has been firmly established, and we do this by making the tough choices to cut the deficit in half in 4 years and reduce the deficit to a level where the overall debt is no longer growing as a share of the economy. If we do not do this, then you are absolutely right: Then we face the risk that Government borrowing will crowd out private borrowing in the future and weaken growth.

Now, when I last served at the Treasury Department in the 1990's, fiscal responsibility helped create a virtuous circle of greater confidence, strong private investment, very strong productivity growth, higher overall gains in income for all Americans, more broadly shared across the American economy. We are a strong and productive country. This is about our will, not about our ability. The great strength of America is that when confronted with extreme challenges, we come together and confront them and lay out a path forward. The American people want to see us do that together. The world is watching us. They want to see us come together and work to solve these problems and get the economy back on track. And I look forward to working with you in this endeavor, and I very much look forward to answering your questions.

[The prepared statement of Secretary Geithner follows:]

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Secretary Timothy F. Geithner
Opening Statement
Senate Budget Committee Hearing
March 12, 2009

Chairman Conrad, Ranking Member Gregg, and members of the Committee, thank you for providing me the opportunity to appear before you today to discuss the President's Budget at this moment of economic crisis, but also of real possibility, for the United States.

What I propose to do in the remarks that follow is to:

- Describe the economic and financial challenges that greeted us upon our arrival in office, and discuss how we are addressing them;
- Lay out the intermediate and long-term threats to our fiscal condition, and explain how the President's Fiscal Year 2010 Budget will return the nation to a sustainable fiscal position; and
- Explain how this Budget puts the nation on a path towards energy independence, better educational outcomes, and a reform of health care that both lowers costs and expands access.

Current Economic and Financial Challenges

The economy suffers from a severe lack of aggregate demand, both from families and businesses – a problem that is driven by a slumping job market, where 4.4 million jobs have been lost in just over a year – the largest number as a fraction of total employment in more than a quarter century and the largest number in absolute terms in over a half century. This problem is made worse by a contraction of demand from many of our key trading partners.

Businesses, facing or projecting fewer customers for their goods and services, are laying off workers or cutting back on their hours or wages, causing families to further reduce their demand and businesses to respond with more layoffs and cutbacks.

This dynamic is made worse by a financial system that is unable to provide the credit necessary for recovery. You can see this across America as families find it difficult to get the financing they need to buy new houses and cars while businesses have trouble lining up the credit necessary to meet payroll.

The contraction in credit is causing more job losses and further declines in business activity, which, in turn, is adding more pressure on the financial system.

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Both our economic and financial problems are being compounded by problems in our housing market, where a record of nearly 2.5 million families faced foreclosure last year, undercutting overall home prices, shrinking Americans' real estate wealth by $2.8 trillion from its peak, causing further reductions in demand, more layoffs and a greater credit squeeze that threatens another round of foreclosures.

You can see the scale of the damage in the recent announcement that the Gross Domestic Product, the broadest measure of the nation's output of goods and services, dropped at a 6.2% annual rate during the final quarter of last year. That was its worst performance in more than a quarter century, and the third worst in more than a half century.

In addition to a deepening recession and financial troubles, the Obama Administration inherited the worst fiscal situation in modern American history, with a federal budget deficit of $1.3 trillion, equal to nearly 10% of GDP – the largest that the nation has faced since World War II – not counting the economic recovery or other legislation undertaken by the Obama Administration.

And we begin our time in office after a long period in which our government was unwilling to make the long-term investments required to meet critical challenges in health care, energy and education.

This is the reality that we face today. These are the challenges that shape both the American economy and the Administration's strategy. I want to outline for you today the President's program for addressing these challenges.

Let me start with our immediate response to the acute problems confronting the country.

A Comprehensive Economic Recovery and Financial Stability Plan

Economic Recovery Plan

Immediately upon taking office, the President and the Administration worked with Congress to enact the American Recovery and Reinvestment Act, a package of targeted investments and tax cuts designed to get Americans back to work and get the economy growing again.

Every agency of government is moving quickly to implement the recovery plan in order to reignite economic growth. We have introduced three of the plan's major tax provisions – the Making Work Pay tax credits of $400 a year for individuals and $800 for working families; a first-time homebuyer credit that could get up to $8,000 into the pockets of those buying homes before December 1, 2009; and a subsidy to ensure that unemployed Americans and their families can keep their health insurance.

We estimate that the plan will save or create at least 3.5 million jobs over the next two years, and will boost GDP – over where it would have been had we not acted – by almost 1% this year and more than 3.2% next year.

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Financial Stability Plan

But reviving economic activity is not enough because without a regular flow of credit to families and businesses, recovery will be impeded. Therefore, we have taken another critically important step.

We have introduced a Financial Stability Plan to get our financial system operating so that it promotes recovery rather than prevents it, by supplying the necessary credit for Americans to once again buy homes, purchase cars, go to college and turn good ideas into flourishing firms.

The stability plan will ensure that banks have the capital cushions they need to keep lending under currently troubled economic conditions and, as a precaution, under even worse conditions as well. It will help thaw our important, but now largely frozen, non-bank financial markets so they can go back to generating the credit that families and businesses must have. And it provides a method for the government to join with private investors to begin buying the mortgage-backed securities at the center of so many of the financial system's problems, but whose resumed trading is so important to the stability of the system.

Homeowner Affordability and Stability Plan

Just as economic recovery requires financial stability, stabilizing our financial system requires us to improve conditions in our housing market.

The Administration's affordability plan will help all Americans buy and refinance their houses by encouraging low mortgage interest rates. In addition, it will offer to help 4 to 5 million homeowners to refinance. And it will help another 3 to 4 million homeowners who are at risk of foreclosure through no fault of their own to convert their unaffordable mortgages into affordable ones.

These three plans form our immediate and integrated response to the nation's economic and financial challenges. All three are carefully linked to our 2010 Budget.

The Budget: A Plan for Fiscal Sustainability and Investments for Shared Prosperity

The President's Budget carries forward and expands upon our immediate response to the acute problems confronting America.

It also marries these efforts to an honest plan for how to proceed after recovery has taken hold and the financial system has stabilized. It lays out how to achieve long-term deficit reduction by reversing the short-term increases that are now necessary to achieve recovery and stability – increases that will have to be substantially reduced in order to get the nation back into fiscal shape. And it provides a blueprint for the investments in health care, education and energy that are so critical to our long-term future.

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Budget Honesty

The President's Budget begins by offering an honest assessment of the dimensions of the problems facing the country in the intermediate and long-term.

The President's Budget ends the practice of only recognizing the costs for overseas contingency operations – such as the wars in Iraq and Afghanistan – for as little as one year at a time and instead acknowledges that there is multi-year cost that must be reflected in the Budget. Although the budget includes estimated costs of these operations in the out-years to be fiscally conservative, these estimates do not reflect any specific policy decisions. Several strategy reviews are underway that will inform out-year costs, and it would be premature at this time to prejudge those reviews.

It takes into account the possibility of a natural disaster such as Hurricane Katrina, instead of assuming that the country will be free of such disasters and the costs of helping Americans put their lives and communities back together.

It ends the practice of assuming an increase in revenues from the Alternative Minimum Tax (AMT). The AMT has been "patched" year after year, but for the first time our Budget reflects the cost of doing so.

It acknowledges that, as expensive as it already has been, our effort to stabilize the financial system might cost more. It establishes a placeholder to help ensure we can cover any additional financial stability costs.

I should note here that the existence of the $250 billion placeholder for financial stability in the President's Budget does not represent a specific request. Rather, as events warrant, the President will work with Congress to determine the appropriate size and shape of such efforts, and as more information becomes available the Administration will estimate potential cost.

Finally, the President's Budget gives a fuller view of the government's finances by looking out ten years, rather than the five years which has been the practice with budgets in recent years.

Reducing the Deficit to Return to Fiscal Sustainability

We have set an ambitious, but economically crucial goal for bringing our deficits down dramatically once the recovery is firmly established and financial stability has returned.

We project that the deficit for the current fiscal year, including the recovery and stability plans, will be $1.75 trillion, or 12.3% of GDP. Of that, $1.3 trillion, or 9.2% of GDP, was already in place when we assumed office.

The President is determined to cut this $1.3 trillion deficit by at least half in four years. The budget would bring the deficit down to $533 billion by fiscal year 2013. More importantly, it would reduce the deficit to about 3% of GDP.

By bringing the deficit down to the range of 3% of GDP, we can keep our national debt – the aggregate total of our past deficits – from growing faster than the economy itself and keep the

size of our debt relative to the economy from rising towards the end of our ten year budget window.

Failure to reduce deficits to this level would result in higher interest rates as government borrowing crowds out private investment, leading to slower growth and lower living standards for Americans.

Key Revenue Provisions in the President's Budget

Our revenue provisions are designed to encourage growth and recovery, improve the fairness of the tax code and support the President's critical priorities in a fiscally responsible manner.

Our recovery plan reduces the overall tax burden on the American economy to help get the economy back on track.

The President's Budget takes up where the recovery plan leaves off, cutting taxes for 95% of working Americans by making permanent the Making Work Pay tax credit of up to $400 for individuals and $800 for families. The Budget provides additional tax relief by expanding the earned income tax credit for lower-income families and extending the American Opportunity Tax Credit that provides up to $2,500 toward higher education. All of these are in the recovery plan that Congress enacted last month, but only in temporary form. The Budget also expands the Saver's Credit as part of the President's commitment to help Americans rebuild their savings.

The President's Budget includes tax provisions to help small businesses. It recognizes that many small businesses are operated as sole proprietorships or through partnerships and other flow-through entities, and leaves the individual income tax rates at which these small businesses are taxed unchanged in 2009 and 2010. By extending the current rate structure for families earning less than $250,000 after 2010, it ensures that 97% of small businesses will receive additional tax relief at that time or see their rates remain unchanged.

Moreover, the President's Budget will provide small business owners with a new zero capital gains rate on new investments in their businesses, which should help them plan for expansion and succession.

In addition, the Budget will help provide more incentives for innovation and increase stability in the tax code by making the Research and Experimentation tax credit permanent.

By 2011, when the economy is projected to have recovered, it will be important for the nation to put in place policies that restore fiscal responsibility. For this reason, our Budget includes revenue changes that become effective at that time. Those making less than $250,000 will not see taxes increase. The marginal rates for the top 2% of income earners will return to where they were during the powerful economic expansion of the 1990s.

The Budget also seeks to restore fairness to the tax code. For example, the Budget proposes to tax the compensation paid to hedge fund managers, private equity partners and others in the same way that we tax the wages paid to ordinary American workers. By closing this "carried interest" provision, the tax code will provide equal tax treatment for wages regardless of whether an individual works as a teacher or a hedge fund manager.

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The Budget addresses the serious issue of the "tax gap," the difference between what taxpayers legally owe and the amount that they pay. Building on the recently enacted proposals to increase information reporting, the Budget includes a new proposal to require additional information reporting for rental property expense payments. We will make additional information reporting proposals when the full Budget is released.

The Budget also seeks to close the "tax gap" by tackling tax shelters and other efforts to abuse our tax laws, including international tax evasion efforts.

The Budget addresses the use of offshore structures and accounts by U.S. corporations and individuals to avoid and evade U.S. taxes. Over the next several months, the President will propose a series of legislative and enforcement measures to reduce such U.S. tax evasion and avoidance.

Some proposals will focus on the rules in our tax code that put those who invest and create jobs in the United States at a disadvantage. We will propose rules to both reform U.S. corporations' ability to defer foreign earnings and deter high income individuals and corporations from using tax havens to avoid taxation.

Path to Prosperity: Investments in Health Care, Education and Energy

The President's Budget will put the nation back on a sustainable fiscal path that is so important for long-term growth. But the Budget is about much more than deficit reduction. In it, the President reverses our government's long neglect of critical investments in health care, education and energy in order to improve the economy's performance and lift the standard of living of this generation of Americans and of future generations.

Investing in Health Care

Without a plan to reform and bring down costs throughout our entire health care system, budget deficits will start climbing again as the costs of Medicare and Medicaid increase with rising overall health system costs. And we will not have taken a single step toward the time when every American – no matter their income – receives the quality, affordable health care they deserve.

In recent years, most proposals for how the government should cope with its rising health care costs have centered on trying to hold the growth of Medicare and Medicaid costs below that of the overall system. But there is wide agreement among experts that this is not a long-term solution for containing health care spending.

Any effort to slow the growth of Medicare's and Medicaid's costs requires slowing down the costs of the overall system and that, in turn, is helped by substantially expanding access to care. To do otherwise would result in economically distorting cost shifts, where those who are covered end up paying higher prices to pick up the medical tabs of those who are not.

That's why this President is committed to achieving a goal that has eluded presidents since Franklin Delano Roosevelt, which is to reform America's health care system to make it less costly, more comprehensive and fairer.

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We already have made a down-payment on this effort by including over $20 billion for health information technology, comparative effectiveness and prevention in our recovery plan and by extending and expanding the Children's Health Insurance Program for eleven million children.

The President's Budget will greatly advance that effort by setting aside a reserve fund of more than $630 billion over ten years to help finance reforms. The fund will be financed on a roughly 50:50 basis from new revenues from those Americans who can best afford this sacrifice and health system savings associated with, among other things, reducing drug prices by speeding access to affordable generics.

Investing in Education

Without the President's new investments, we risk leaving a generation of workers unequipped to compete in the 21st century's global economy. In order to ensure that our workers are prepared to compete and that the economy can continue to grow, we must increase the number of Americans who have the opportunity and ability to earn a college degree.

This is particularly important because of the projected slowdown in the growth of our labor force over the coming decades. And it is particularly important for those in our society – such as those from minority and lower-income families – who have traditionally had lower rates of college success.

In this light, the higher education provisions in the President's economic recovery plan are essential to our long-term economic strategy because during periods of economic stress, the students who are most likely to drop out or never attend college are those for whom cost is the biggest barrier.

The President's Budget includes substantial strides towards ensuring that a college education is affordable for all Americans. The American Opportunity Tax Credit will provide up to $2,500 a year of tax relief for a student going to college. The combination of the partially refundable nature of the credit and a sizeable increase in the maximum Pell Grant to $5,500 a year embodies the President's commitment to ensuring young people at all income levels can obtain a college degree.

At the same time, the President's Budget ensures that more young adults will be ready for college by starting them on the right track in early childhood.

The President's commitment to quality early childhood education reflects the belief of experts ranging from child psychologists to the Minneapolis Federal Reserve and Nobel Prize-winning economist James Heckman that these programs are among the highest-paying investments not only for children, but for the economy as a whole. That is why the President's Budget includes measures to help states improve their early education programs, along with funding to expand Head Start and double the number of children in Early Head Start.

Investing in Reducing America's Dependence on Foreign Oil

Without the President's new investments, the nation will remain dependent on uncertain supplies of foreign oil and carbon-intensive energy – a dependence that threatens our economy, our environment and our national security.

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The President's energy investments reflect our efforts to use broad-based market incentives to move us as efficiently and as quickly as possible towards a clean energy economy, while also providing relief to those who may bear a temporary increase in expenses during that transition.

The recovery plan includes $65 billion in investments in clean energy technologies for programs like creating a smart electricity grid, improving energy efficiency, and investing in green jobs. As the President has made clear, we will work with Congress to develop an economy-wide emissions reduction program to bring emissions down approximately 14% from 2005 levels by 2020 and approximately 83% from 2005 levels by 2050. This program should include a 100% auction of emissions allowances – ensuring that the biggest polluters don't profit on the basis of past pollution – and should use a cap-and-trade system that has worked effectively in the past as a mechanism to combat acid rain.

The funds raised through this auction could be used to invest an additional $15 billion a year in clean energy technologies. It would also go towards covering the cost of making the Making Work Pay tax credit permanent, providing 95% of American families with tax relief. If there are any additional revenues, those could go back to the American people, with a focus on compensating vulnerable communities, businesses and families.

The government will set the example by, among other things, retrofitting its buildings in order to improve their overall efficiency and save taxpayers billions of dollars.

In all of the President's Budget proposals, as in our recovery, stability and affordability plans, we will make good on the imperatives set by the President to operate in the bright light of day so that taxpayers can know how their money is being spent and can hold us accountable.

The problems that confront this nation are daunting. But we are a strong and resourceful country. Faced with great challenges in the past, we have shown the will to overcome adversity and carve a path back to prosperity. We will do so again.

A budget is about more than columns of numbers and trend lines across a page. This Budget embodies our values, our aspirations, and our will to overcome the current crisis and usher in a new prosperity.

I look forward to working closely with you in this great endeavor.

Chairman CONRAD. Thank you, Mr. Secretary, and thank you for that excellent opening statement. And, again, I want to recognize the extraordinary responsibility that is on your shoulders and what I am sure is an extraordinary workload, and we appreciate very much your coming before this Committee for what is a very important conversation about the document that is going to be the blueprint for our country going forward and what should that blueprint reflect.

One thing I wanted to put up is, looking at credit markets, the most encouraging thing that I have seen—this is something we monitor very closely in our office—is the TED spread, the difference between the London Interbank Offered Rate and the Treasury borrowing rate. And what we saw last fall was truly stunning and of deep concern, because the TED spread spiked very dramatically at nine times its typical difference. Nine times its typical difference. That told us that banks' perception of borrowing from one another had gone off the charts. And we have now seen a very dramatic improvement in the TED spread.

By the way, this difference in the TED spread had led me to believe a year ago in December that we might be headed for trouble, because we saw a spike then in this critical rate.

If we look at commercial paper spreads, we see the same thing, a very dramatic improvement—very dramatic improvement in the commercial spreads. In fact, if I had a chart showing that, it would very closely mirror this chart. Commercial spreads have come way down.

With that said, we still have this issue of the toxic assets ricocheting around the global financial system, continuing to put at risk institutions and continuing to lock up credit markets. I had a very distinguished businessman call me, had a $12 million credit line, never late on a payment, never missed a payment, and his credit line was pulled—not because of anything wrong with his business, but because the bank's own balance sheets were so impaired that the regulator insisted they start to pull back on some of their lending.

So what can you tell us, first of all, with respect to this measure that I have closely watched for a long period of time? And I find very encouraging that it has almost returned to normal. It is still not normal, but dramatically improved from where it was. How important do you take that to be, as well as the commercial market spread's improvement? And what can you tell us about the toxic assets and the plan to deal with that?

Secretary GEITHNER. Thank you. Let me just start by saying you are both absolutely right that recovery depends on getting credit flowing again, and without very forceful action to make sure banks have the ability to lend, even in a deeper recession, and without continued action to get these credit markets working again, then recovery will be undermined and the effect of the very powerful Recovery and Reinvestment Act will be not as powerful as it needs to be in this context.

Now, you are right that those measures of risk in some sense have come down dramatically. The one other thing I would cite in this context is that if you look at what has happened to mortgage

interest rates, they have also come down dramatically. And that is, of course, critically important to families across the country.

Now, it is going to take more, though. We have not seen enough progress. And you have heard from your constituents across the country that businesses, good businesses, viable businesses, are seeing lines cut and withdrawn, and it is for exactly the reason you said.

One qualifying point, though, before I come to the toxic asset thing. It is important to recognize that our financial system—you know, we have 9,000 banks in the country. We have thousands of community banks. The vast majority of these institutions were not part of the problem, and they are going to be an important part of the solution. And you are seeing the strong, well-managed institutions expand, as they should in this context. And it is important that we not tar the system with the basic broad brush we are seeing expressed in much of the commentary in this context.

Now, you are absolutely right that the basic dynamic at work here is that many institutions made a lot of bad loans. Those loans are still on their books. They cannot sell those loans because the markets are not working, there is no financing available.

One example that is helpful to use is if you had to sell your home tomorrow in a market where nobody could get a mortgage, the price you would get for your home would be far, far below what you would normally expect to get in a growing economy where financing is available. And that is part of what is causing this system to be so defensive and pull back.

Now, markets look forward, and part of the uncertainty you are seeing in markets is the markets are looking ahead to the scale of potential losses on those bad loans that might occur in a deeper recession. And that is in some sense forcing behavior by some banks that is making them defensive and pulling back. And to arrest this, we have to do two things:

We have to make sure that we provide a more careful, transparent, realistic assessment of the potential losses banks may face if we go into a deeper recession. When you look under the hood a little more carefully, which we are doing, we need to make sure there is capital available to them for those that need it, and some will need more capital. The Government has to provide a backstop in that context. And we need to provide a mechanism to help them sell these bad assets, get them off their books, clean up their institutions. That will put them in a position where it is going to be easier for them to raise private capital and replace the Government's investments with private capital as soon as possible.

So the mechanism we are going to use is to provide Government financing alongside private capital that will make is easy for banks to get rid of and unload these assets. And, again, that will make it easier for them to present a cleaner, stronger institution and bring private capital into their institutions going forward. And this is something—because this crisis is so different from past crises, it requires different approaches, and to solve it we are going to have to work with the market, because we do not want the taxpayer and the Government taking all those risks on the Government's balance sheet and leaving the Government with huge, incalculable losses, risks we cannot manage effectively, so we need to find a way to

work with the market to help solve that problem. That is what our plan is designed to do.

Chairman CONRAD. All right. We are going to have 6-minute rounds, given the level of interest here today. I think that is the only fair way to do it, and I will impose that limit on myself.

Senator GREGG.

Senator GREGG. Thank you, Mr. Chairman.

Let me just respond quickly to your opening statement. I want to just make a statement relative to what you said about your budget, because I really have fundamental disagreements with the way you characterized it. You said essentially that you are controlling spending. Well, you are not.

Can you put up the spending chart?

When we get into your budget in the out-years, spending as a percentage of gross domestic product is at 23 percent. Now, you argue that you control discretionary spending. You say you maintain it at 3.1 percent or 3.2 percent of the total budget, or whatever your calculation was, which is less than the historical number.

Well, maybe you do, but if you do it, it is primarily because you are moving things from discretionary spending over to entitlement spending. You are taking the Pell grants and moving $100 billion off the discretionary accounts into the entitlement accounts.

And then you said, well, and we really do manage the spending except for the fact that we do not address the issue of entitlements being impacted by the retirement of the baby-boom generation. Well if you do not address that issue, you are not addressing the spending of the United States. I mean, that is at the core of our spending problems. And so—I will give you a chance in a second. I want to make this point. You cannot claim that you are being disciplined if you leave off the table the most significant item that has to be addressed.

Now, maybe your argument is, well, we are going to address health care and, therefore, we are going to address the entitlement issues. Well, how do you address health care? Health care today takes 17 percent of the gross domestic product. You are suggesting that it be increased as a percentage of gross domestic product. You are adding another $664 billion in your budget, which you say is a downpayment on the entitlement accounts relative to health care, which is probably a downpayment that is only about half of what you think you really need. It is probably closer to $1 trillion, $1.2 trillion.

So you are exploding the size of health care spending on top of health care spending which already exceeds any other industrialized country in the world by about 5 percent of GDP. So there is no discipline there. In fact, there is a massive expansion of the Government.

And in the area of revenues, you are claiming, well, we are going to go back to the 1990 revenue levels. We are going to get to 18.2 percent of gross domestic product. Well, that gives you a structural deficit of 5 percent of GDP. If you are at 23 percent of GDP for spending, and you only get your revenues up to 18.2 percentof GDP, you have got a structural deficit of 5 percent of GDP.

Why are you going to back to the 1990's? Why don't you go back to the Bush years when revenues were up to 18.9 percent of GDP?

Why were they at 18.9 percent of GDP? Because we had a tax policy structure in this country which encouraged productivity and allowed people to take risk capital and make money on it and thus create jobs and thus create revenues for the Federal Government. What are you doing? You are clubbing—clubbing—risk capital. You are taking and creating a 30-percent tax increase on capital gains. You are saying to the people who are small business people, we are going to increase your taxes from a 35-percent to a 42-percent effective rate. And then you are claiming, oh, we are going to have to be more productive. Of course, we are not going to be more productive. That is why you cannot get your tax revenues up because you are basically saying to the productive side of the ledger we are not going to allow you to be productive.

Secretary GEITHNER. Senator, could we go through these——

Senator GREGG. Just as second. I have got one more point here before we go through them. I am going to run out of my time.

You say the markets look forward. The markets are looking forward. They are looking forward and saying, Why would we invest in the United States when we are going to see a massive expansion of the Government that will burden this country in a way that it cannot afford? It creates a doubling of the national debt in 5 years and a tripling of the national debt in 10 years. Why would we invest in a country where the debt is going to be unsustainable, where the deficits are unsustainable, and where they are basically saying if you are a productive individual, a small businessman who wants to take a risk, we are going to penalize you, we are going to go out and club you with a massive new income tax. And then when you try to sell your little small business, you know, the little restaurant that you wanted to sell to the big restaurant chain, we are going to hit you with a 30-percent increase on your capital gains rate. Hit you twice, you know?

I do not see how your budget does anything other than put us in a position where we get a Nation that our children cannot afford and that is not productive.

Secretary GEITHNER. Senator, can I respond now?

Senator GREGG. Of course.

Secretary GEITHNER. Could we go back to that first chart?

Senator GREGG. Yes. Go back to the spending chart.

Secretary GEITHNER. This is a very important thing to go through. A significant part of the resulting level of spending to GDP I just want to say is interest cost based on the essential result of the inherited deficits and the cost of fixing this crisis.

Now, you are right that part of that increase is the effect of the aging population and rising health care costs on entitlement spending.

Now, as you know, the President brought the leadership of the Congress together——

Senator GREGG. May I just——

Secretary GEITHNER. Part of it——

Senator GREGG. Doesn't that require you to take action which reduces interest costs in the out-years?

Secretary GEITHNER. Absolutely. And what the budget does——

Senator GREGG. But you are creating a deficit——

Secretary GEITHNER. And, again—no, what the budget does is propose to bring the deficit down to 3 percentage points of GDP 5 years out, and to keep it in that range over the next 5 years. And what that means is the debt-to-GDP ratio will stabilize, and that ultimately is a test of sustainability.

Now, you are right if we——

Senator GREGG. No, a debt level of 67 percent of GDP is not sustainable.

Secretary GEITHNER. No——

Senator GREGG. And if you look at the last 20 years, deficits ran at about 2 percent of GDP.

Secretary GEITHNER. No, but the judgment of sustainability of all economists across the spectrum is what level of deficit stabilizes the debt-to-GDP ratio at reasonable levels. And 3 percent is roughly the band which achieves that, and that is the test of what the economy can bear.

Now, you are absolutely right. This is a proposal for his this Nation could be fiscally responsible and live within our means. It is a proposal. It requires Congress to come together and agree to make these tough choices.

Now, you are absolutely right that we then need to bring down entitlement costs, but as you acknowledge and your colleagues have acknowledged, the only way to do that and the necessary condition for doing that is to reduce the growth of health care spending.

Now, you have said several times this is a dramatic expansion in the size of the Government relative to the economy. Now, again, if you take out interest costs and you take out the modest increase forced by the aging of the baby boomers, this is a change in priorities for the country, but it is not a significant growth in the overall size of the Government to GDP. And, again, the critical test for long-term growth is: Is that deficit going to be brought down and held at a level where the debt burden is manageable and stable?

Now, that is something that we cannot do alone as an administration. It requires Congress, both sides of the aisle coming together and saying, yes, we are willing to commit to that path of responsibility. So we have to start with that path, and it has to come with meaningful reductions in non-defense discretionary spending.

Now, you are right that that is not going to be sufficient, but it is the necessary of it, and this is a very ambitious, fiscally responsible deficit.

One last very quick point. You said several times in your opening statement that the tax increases that this budget proposes on the most affluent Americans, it will come only after recovery is established—not this year, not next year, only beginning in 2001, when private economists all believe recovery will be in place. Those increases in taxes, again, restore us to the level that prevailed in 2001, and they will affect only 2 to 3 percent of small business owners across the country. Only 2 to 3 percent.

Now, you can look at independent assessments of that, and we can debate that impact. Those are not our estimates. Those are estimates of independent economists.

Now, to say that this budget proposes to substantially increase the tax burden on any meaningful fraction of small business in the country is just not a fair representation.

Now, we will have different priorities, different judgments about what is going to get the economy growing again, but there are very few economists who would not agree that addressing the growth in health care costs, improving educational outcomes, improving our infrastructure, and moving us to a cleaner energy economy are not absolutely necessary conditions for improving the long-term growth potential of this economy.

Senator GREGG. And reducing debt and deficit to a sustainability level is at the core of accomplishing that.

Secretary GEITHNER. Absolutely at the core. I completely agree.

Senator GREGG. Which is not accomplished under this budget.

Secretary GEITHNER. But, Senator, if your proposal is we should try to go lower in terms of deficits to GDP in the out-years, lower than 3 percent of GDP, then we would be happy to work with the Congress on how to achieve that. And that is the reason——

Senator GREGG. Start with entitlements.

Secretary GEITHNER. But that is the reasonable proposition. But 3 percent of GDP is a fiscally sustainable deficit path. The hard thing is to achieve it, not to propose it. The hard thing is to achieve it, and, again, what this budget does is it outlines very concrete, very specific ways for doing that, and that is why you are seeing so much concern raised about some of the specific provisions. A test of credibility is are we proposing things that are going to be hard, and these will be hard things to do, and they require the Congress to come together to act.

Chairman CONRAD. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman.

Mr. Secretary, the Chairman gave an example that has happened to a lot of us. He gave an example of a constituent that had a $12 million loan, never missed a payment, had perfect credit throughout his life, and suddenly the bank is calling the loan. Now, this is happening to every one of us.

You made a statement that it was the regulators that are coming in there and requiring——

Secretary GEITHNER. That was the Chairman's statement, but I would like to address that.

Senator NELSON. OK. Then my question to you, and, please, we are all interested in this: What do you do to control the regulators so that they are not working at cross purposes with what we are trying to do to restore the economy? And the regulators, I assume, work for the Treasury Department.

Secretary GEITHNER. Well, as you know, we have a rather complicated supervisory structure. We have something like 64 bank regulators across the country. But your point is absolutely right. We need to make sure that strong banks are lending to strong, viable companies.

Now, it is very important to step back and recognize that, you know, we had a huge, unsustainable growth in borrowing across our country, and we are living with the consequences of gravity being restored. And that means that demand for credit will fall, necessarily. But what we have to make sure of is that you do not

have the supply of credit constricted and, therefore, pushing businesses to the point where they cannot meet payroll, cannot make the investments, are at greater risk of failure. And everyone we are doing in the financial system is designed to arrest that dynamic and, again, make sure that you have enough credit for viable businesses to do what they need to do.

Now, the regulators face a very difficult balance, and it is very important that the supervisors across the country are not making it harder, again, for strong banks to lend to viable businesses. And I know that my colleagues and counterparts at the national level responsible for bank supervision are trying to be as careful as they can in sending out that guidance. They issued a statement together back in the fall. We have been encouraging them to stay on it, to be very careful that they are sending a balanced message, and I agree with you completely that is an important part of a way to get small business lending to the point where it is supporting recovery.

Senator NELSON. So does that mean that the regulators are going to start being more realistic about the poor guy who has never missed a payment and they are not going to require the bank to call the loan on him?

Secretary GEITHNER. Again, you are absolutely right. you want to make that the supervisors are not making this thing harder than it already is.

Senator NELSON. Well, they have been in my State, and I assume in the Chairman's State.

Secretary GEITHNER. Well, I know there is as lot of concern about this, and, again, I think that we have tried to make it clear to the supervisors that they need to send a more careful, clear, consistent message across the country so that we are not amplifying those challenges.

Senator NELSON. Well, I do not know how you do what you do, and you do not have a lot of your subordinates in place. But I would think that that would be a very important message for you to get out to all of these supervisors, that we ought to all be in the harness pulling in the same direction. And they are pulling in the opposite direction right now.

Now, let me tell you one thing that is a problem in your proposed mortgage relief for my State. You only allow mortgage relief for a mortgagee if their mortgage is only up to 105 percent of value. That is not the case in Florida. The real estate market has dropped like a rock, and, therefore, a person's home is worth a lot less than a mortgage being underwater that much.

So what can we do for places like Florida and Nevada and California—and, of course, I have in one part of my State the highest mortgage foreclosure rate in the country, and we want to help them. But your regulations are not going to help them.

Secretary GEITHNER. Senator, thank you for raising that. It is very important to start by recognizing that what is happening in housing requires recovery. To arrest it, it really does require that we reduce the risk that unemployment rises more than it has already likely to rise, and that we get the credit markets and mortgage markets working again. Those are necessary conditions. They

are not sufficient, but the President's plan does three very important things.

One, it is designed to help get mortgage interest rates lower, and even since the announcement, those rates have come down significantly further. That benefits all Americans who own a home, would like to own home, or need to borrow to refinance.

The second thing is to make it easier for Americans to refinance to take advantage of lower interest rates, even if the loan-to-value ratio of their house has gone up beyond the normal 80-percent threshold that the GSEs can finance. And what you are referring to specifically is this refinancing program, and you are right that that program is only open to people who have loan-to-value ratios between 80 and 105.

But the third piece of the President's program would provide strong incentives to reduce mortgage payments through principal and interest reductions for a set of Americans that could potentially have much higher loan-to-value ratios in their house. And that third part of the program is the first time we brought the entire arms of the Government together—the GSEs, the FHA, the FDIC, the bank regulators—and we issued just last week, I think last week, a set of standard modification provisions that will help provide substantial payments relief to millions of Americans, even with Americans whose loan-to-value ratios are above 105.

Of course, you want to make sure that is going to produce a viable, economically affordable mortgage payment, and it will not benefit many Americans who really borrowed way, way beyond their means.

And just let me end with this. Of course, you know, the tragic thing about financial crises is they cause damage not just to those who were irresponsible, but to those who were very careful and prudent in their financial decisions, and through no fault of their own are left facing the prospect of diminished access to credit, lower home values. And that is why in a case like this, there is such a powerful imperative for the Government to act forcefully.

I hope that was responsive, but the core part of this more affordable payment scheme will reach a broader class of Americans—not all Americans but a broader class of Americans—than the refinancing program.

Chairman CONRAD. I thank the Senator.

Senator Sessions?

Senator SESSIONS. Thank you, Mr. Chairman. And, Mr. Secretary, I appreciate your work. You have got a lot of challenges and a lot of difficult problems to deal with.

I would just say to you, in my opinion, your statement today is a disappointment. I do not think it is an honest and responsible appraisal of the condition that we are facing today. And I do believe that as Secretary of the Treasury, with the kind of power that you have, you need to get out of the campaign mode. I know you have responsibilities to the administration, but this sounds a lot like David Axelrod to me rather than a fundamental appraisal. So we need to work together to come up with a better assessment.

I think you should listen to Senator Gregg. What he is saying is that we are not going to accept numbers that we do not think are responsible. We are going to have to deal with the reality. I think

Wall Street is expecting that, and they are not confident that they have got it yet.

This budget at its base is more taxes, more spending, and more debt. I do not think anybody can debate that. And you cannot have, as Senator Gregg suggested, an 18-percent GDP revenue base while we are looking at a 23-percent spending rate. That is the problem that faces us.

Could I ask you one thing? But first I want to say to my distinguished Chairman and Ranking Member, I know that you were in meetings, and you were told that this TARP had to pass so we could buy toxic assets. My question is: Who told you that? And was the economy in total collapse, facing total collapse? You were not, I do not think—you may have been in that room. You were certainly with Mr. Paulson. But Mr. Paulson told us he was going to buy toxic assets with it. A week later, he was buying stock in banks. So from the beginning, they don't have any credibility with me. I have doubts about it.

With regard to that particular item, Mr. Secretary, I am hearing that some Main Street banks that are participating in the TARP program—I am talking about Main Street banks, not the Wall Street crowd, where you are from—that they were forced to the table, strongly encouraged to participate in the first phase of this Capital Purchase Program. It was sold to them as one thing, and then the rules changed. But many of these Main Street banks would like to pay back their TARP money to the Government and terminate their relationship with the Government. This would seem to me to be a good goal for the country and the taxpayers and would be a signal of some progress.

However, I understand you are proposing a second injection of capital from the Federal Government into these banks, and I think many of them do not want it.

My question is: What is the Government's objective in conducting the stress test that the Government is currently conducting on the banks? What is the ultimate goal? And what if some of these more well-managed Main Street banks want to pay back their Phase I capital and get out from under the Federal Government? What is the position there?

Secretary GEITHNER. Senator.

Secretary GEITHNER. Senator, thank you. Can I just start with one point? I have been in public service my entire professional life, never worked on Wall Street, never worked for a financial institution. I worked——

Senator SESSIONS. Well, you supervised Wall Street, sort of, at the Federal Reserve.

Secretary GEITHNER. You are absolutely right, as part of my responsibilities, I have worked in——

Senator SESSIONS. That is the culture that you were part of, but I accept your response.

Secretary GEITHNER. My obligation to the American people is to protect the financial security of this country and to protect our financial system, not because we are here to do anything for banks. I would not give a penny to help a bank. The only thing we are doing is we are trying to make sure that credit is available on a scale and terms necessary for recovery to come back. And there is

no way we are going to get recovery in the speed and force we need unless we do a better job of achieving that outcome.

Now, you are absolutely right, and nothing would make me happier to see strong banks repay the Government the capital they took, and we would love to see banks go out there and replace that capital with capital from the private sector, repay us, and allow us to use that for where it can be targeted next.

One thing I really want to say, you know——

Senator SESSIONS. Is there hesitation, is there any reluctance whatsoever——

Secretary GEITHNER. No reluctance——

Senator SESSIONS [continuing]. On the part of Treasury to have that happen?

Secretary GEITHNER. Again, as long as they replace that with private capital so that they are, again, able to provide lending to the economy, then that would——

Senator SESSIONS. What do you mean as long as they replace it with private capital? What if their stress test report indicates they do not need more private capital?

Secretary GEITHNER. Well, then they are in a good position——

Senator SESSIONS. And they are willing to pay you back.

Secretary GEITHNER. Then they are going to be in a good position to repay the Government and replace that capital. So to the extent that happens, that will be a good thing. Now——

Senator SESSIONS. Wait a minute. If they do not replace that capital, are you then going to tell them no, they cannot give back the money to the Government and get out from under your boot?

Secretary GEITHNER. Well, Senator, I just want to say one thing. I was not Secretary of the Treasury until about 6 weeks ago.

Senator SESSIONS. I understand that. You are right.

Secretary GEITHNER. And although I support many of the actions that were taken by the Congress over that period of time. And you are absolutely right, Mr. Chairman and the Ranking Member, that what was done back then was a necessary thing to stabilize our system. But I was not Secretary of the Treasury then.

Now, my job now is to make sure that, where it is necessary for banks to have additional assistance so they can do what they need for recovery, we do so on conditions that are going to make sure there is more credit available and that they emerge from this stronger. That is my basic responsibility.

And I want to say, just to—can I come back on the stress test thing, or do you want me to come back later, Mr. Chairman?

Chairman CONRAD. Well, the Senator's time has expired. If you have just some——

Senator SESSIONS. But the question was ongoing. I do not think——

Chairman CONRAD. Wait a minute, Senator. Senator, your time has expired.

If you have some final point that you wanted to make in response, we can do that.

Secretary GEITHNER. Just very quickly. We are doing what I think any American would understand, which is that we want to make sure that we understand and the world can see how strong these institutions are and where some may need an additional buff-

er of capital to get through this challenging economic environment. To do that, you have to look carefully under the hood and bring a more consistent, realistic, forward-looking assessment of what potential losses may occur across the system. That is a necessary, completely sensible, reasonable thing for the Government to try to do, and it is in the interest of these institutions, because right now they are living with a cloud of uncertainty which is causing them to be more defensive and withhold lending. And we need to arrest that basic dynamic.

But I hope and expect—and I believe it will be possible—that many banks will be able to repay the Government the capital they initially took.

Chairman CONRAD. Let me just stay this to my colleagues. We are not going to make it at this rate because people are going over their times, and I mean not just a little bit over.

Senator SESSIONS. I was just 1 minute.

Chairman CONRAD. Yes, I know, it is 1 minute here and 2 minutes there, and pretty soon we are not going to make——

Senator GREGG. Is that like trillions?

Chairman CONRAD. Yes, it is sort of like that. I just ask all of our colleagues, and I would ask the Secretary—you have a full right to respond. I want to absolutely give you every chance to respond here. And to colleagues, please respect our other colleagues.

We have next in order on our side Stabenow, Cardin, Sanders, Murray, Warner, and Whitehouse. On the other side, Senator Bunning will be next, Senator Crapo, Senator Graham, Senator Alexander.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman, and welcome, Mr. Secretary. This discussion or debate going on reminds me very much of the debate we have had for the last 8 years, the ninth year of my being in the Senate and on the Committee. And with all due respect, say I welcome an administration and a Secretary of the Treasury that is putting forward an honest budget that shows all of our debt, does not pretend that the war does not cost anything, and is including all of the challenges that we have.

I remember when our previous Vice President said that deficits don't matter, and, in fact, we all know that they do. But to me this is very much about the old solutions that were in place, that were tried with a different administration, a different majority, and trying to do something new, having a different view, a different set of values and priorities.

And so I want to just start out by commending you for having a budget that is a net tax cut for the middle class of this country, for putting together the true costs and issues that deal with economic competitiveness for businesses and families. When someone sits around a kitchen table, they do not compartmentalize their health care bill, the cost of sending the kids to college, and what is happening when they are trying to pay for gas or their energy costs. It is all part of their budget. It is all part of the challenges. And, unfortunately, you find yourself where you have inherited a terrific mess, economic mess, and inaction on all of these issues. And so I commend you for pulling this all together, which is very, very tough to do.

I also want to indicate that we have said for years that we have to invest on the front end to get savings, and it is always hard. It is hard to do prevention even though it saves money. It is hard to do up-front costs like health information technology even though you know it saves, creates quality, saves on costs. It is hard to deal with issues around energy on the front end. But I want to thank you for that as well, because this budget really does reflect being responsible about how we get where we want to go to save dollars.

I want to ask you a question, though, related to up-front costs. You have in here in the overall budget a National Infrastructure Bank, which I commend you for, to deal with long-term infrastructure investments. And also there are dollars in the budget that deal with alternative energy investments, new technologies, which I also commend you for, as a State where we can make those technologies, and I see that very much a part of our future.

My question to you is—the clean energy piece is tied to the cap-and-trade program, $15 billion tied to cap-and-trade. And I very much want to see that separate, not because I am not supporting doing something on cap-and-trade, because I am and have very specific ways that I believe that we can work together to get there. But I also believe that we can't wait, that the alternative energy, clean energy investments on the front end are critical for us to be able to meet cap-and-trade.

And so my question is: If we put forward—and I would like to work with you on this budget, putting forward a clean energy fund that would be within the context of this budget, but would not be tied to the cap-and-trade regime specifically in case this takes a little bit longer to get done, and I am wondering your thoughts about that.

Secretary GEITHNER. Senator, thank you. I think I should start by saying in the Recovery Act which you passed, there are very, very substantial investments already——

Senator STABENOW. Absolutely.

Secretary GEITHNER [continuing]. In clean energy technologies, and, in fact, they are much larger, I believe, if you account for them correctly, than the proposed $15 billion piece of use of resources potentially raised by cap-and-trade. And so we are not waiting, and I think you are right that it is very important not to wait. This is too important to wait, and we need to move now.

The Energy Department and other arms of the administration working with Treasury are trying to move very, very quickly to put those programs in place because it is important to do.

Senator STABENOW. Well, what I would ask that you look at again is that in the recovery plan—and I was pleased on the Finance Committee to be a part of putting together the manufacturing credit and extending the investment tax credit and production tax credit, there is a cap, particularly on the manufacturing credit, in terms of the value of the credit that will be allowed overall. And we will exceed that on the manufacturing credit.

There is an explosion there in jobs, in green energy, and interest that is going to exceed that cap very quickly. And so I would just ask that you work with us in order to expand that.

Thank you, Mr. Chairman.

Secretary GEITHNER. Thank you.

Chairman CONRAD. Senator Bunning is next.

Senator BUNNING. Thank you, Mr. Chairman.

Secretary Geithner, I see in the press that you have a plan to save the world's financial system. Where is your plan to rescue the United States system? We have been waiting for that.

Secretary GEITHNER. Senator, thank you for raising that. We have moved—again, we have been in office 6 weeks. In that period of time——

Senator BUNNING. No, but you—excuse me.

Secretary GEITHNER. I just want to say this. Let me explain what we have done——

Senator BUNNING. But do not—no, I am not going to let you do that, because you were part of the problem. You were the head of the Federal Bank of New York. You sat in on the meetings on TARP when it was decided. In fact, they give you credit for it being your plan, the former Secretary of the Treasury does.

Secretary GEITHNER. Senator, lots of people——

Senator BUNNING. And Ben Bernanke has not denied that before our committees.

Secretary GEITHNER. Senator, lots of people are giving me credit, and lots of people are going to be blamed for lots of different things. But let me——

Senator BUNNING. I did not blame you for it. I said you are credited for it.

Secretary GEITHNER. But let me just respond to your initial question. We have got to move and we are moving very quickly. You have not seen a Government move this quickly to address a crisis of this magnitude ever before. Remember, it has been roughly 6 weeks since I took office, and in that period of time, we have launched this very powerful housing program to get to the heart of this crisis. We have started this very powerful program with the Fed to get lending going into small businesses and consumers. We have laid out a program for strengthening our Nation's banks with detailed terms on the capital they have the potential ability to get from the Government—all in this short period of time.

We have proposed very substantial reforms to the conditions that come with our assistance, not just on dividends, on compensation, but on lending and transparency and accountability——

Senator BUNNING. Mr. Secretary, I have got 6 minutes, and I want to ask some questions.

Secretary GEITHNER. And this is a global crisis. It is in the interests of the United States that we have a global response, and export prospects for American businesses across the country will depend in part on how effective we are getting other countries to move with us——

Senator BUNNING. Thank you. Last week, AIG's bailout brings the total to about $180 billion. I do not understand how one company is worth propping up with $180 billion worth of taxpayers' money, and I do not think the American people understand it either. So tell us, why do you keep bailing out AIG? What is the risk? And who are the counterparties that we are really trying to save?

Secretary GEITHNER. I agree, it is an outrageous thing for our Government to be in the position where a company was allowed to

get to the point with no constraints that their future is critical to the future of the financial system. Now——

Senator BUNNING. Have you seen this report?

Secretary GEITHNER. I do not see what it——

Senator BUNNING. Well, it is a strictly confidential report: "AIG: Is the Risk Systemic?" It was supposed to be the document they presented to you all or the Treasury for the fourth tranche of money that they got.

Secretary GEITHNER. Senator——

Senator BUNNING. I got it from the New York examiner of insurance.

Secretary GEITHNER. I am happy to look at it, but I will tell you my judgment. AIG is systemic. I wish it were not the case. But AIG is systemic, and the least cost way to the American taxpayer and the American people for dealing with that risk is to help this company restructure and get to the point where——

Senator BUNNING. Where is the bottom line, Mr. Secretary?

Secretary GEITHNER. The bottom line is that our job and my responsibility is to protect the security of the American financial system——

Senator BUNNING. Where is the bottom line for the American taxpayer dollar-wise?

Secretary GEITHNER. The bottom line is that we have to make sure, given the severity of this crisis and the fragility of this system, that we do everything necessary to protect against the risk that we have a disorderly failure of a major financial institution. I mean, just look back to what happened in the fall——

Senator BUNNING. I did.

Secretary GEITHNER [continuing]. And look how that——

Senator BUNNING. I disagreed completely with what you did.

Secretary GEITHNER. No, but remember, I was—if you look at the consequences for the American economy——

Senator BUNNING. I have looked at the consequences.

Secretary GEITHNER. But if you look——

Senator BUNNING. I looked at Bear Stearns. I looked at Lehman Brothers. I looked at all the things that were going on at the time and disagreed completely with what was happening.

Secretary GEITHNER. And, Senator, I do respect your views on this, and I understand your concerns about it. But this is a basic judgment about what is necessary to protect the stability of the American financial——

Senator BUNNING. Thank you.

Secretary GEITHNER. And that is my job and responsibility——

Senator BUNNING. Thank you.

Secretary GEITHNER. And AIG is systemic.

Senator BUNNING. The first thing that France did when they went socialistic was nationalize the banks. We have skirted nationalization of the banks under you and the amount of money that we have been putting in banks all over the country.

Now, we will not call it "nationalization" because that is a bad word, but if you tell me how many banks have accepted money from the Federal Government, I will give you a little better idea on what nationalization is.

Secretary GEITHNER. Senator, are you speaking in favor of nationalization or against it?

Senator BUNNING. No, no. I am——

Secretary GEITHNER. Against it.

Senator BUNNING. That is really funny.

Secretary GEITHNER. No, I was not trying to be funny. I just want to make sure I understand.

[Laughter.]

Secretary GEITHNER. You said we skirted it, but you were not praising me, I thought.

Senator BUNNING. No, I am not.

Secretary GEITHNER. OK. So the information on who has taken money from the Government in terms of capital and the amount of capital——

Senator BUNNING. How many banks?

Secretary GEITHNER. It is publicly available on the website. It is in the hundreds. But what matters is the amount and terms of that capital.

Senator BUNNING. Well, OK. I understand all those things. I have a community banker who attacked me out in Paducah, Kentucky, on FDIC assessment. Their assessment went up 1,000 percent. They are getting charged, and did not have any failures, for those who failed. Explain that to me.

Secretary GEITHNER. You are absolutely right. I think this is a deeply unfair thing, and it causes concern across community banks across the country. You are absolutely right. The way our system is designed is the FDIC is obligated under law to assess a tax over a period of time—to raise the premium over a period of time across the entire financial—and that does create this problem that people, again, who were responsible and ran well-managed banks are bearing the costs of the decisions made by others. And that is a deeply unfair thing. But that is the way the system as designed by the Congress is applied. And I think it is very important that we work together to make sure——

Senator BUNNING. We will work together to change it. Thank you.

Chairman CONRAD. Thank you, Senator.

Senator CARDIN.

Senator CARDIN. Thank you, Mr. Chairman.

Secretary Geithner, first let me tell you what I like about the Obama budget. I think it is an honest budget. You have included in the budget the real cost of Government, and that is refreshing. It is aggressive in dealing with the short-term problems that you inherited, including large deficits and an economic crisis. And it invests in America's future so that our long-term prognosis will be much better, by including health care reform, and energy and education policies.

But let me share with you the concerns that the Chairman has raised about long-term financial viability of the economic plan that you have presented. I say that because, first, the Administration's success depends upon Congress responding to your requests on health care, energy, and education. I certainly hope the budget resolution that passes Congress and the actions of our committees will accomplish that. And I will do everything I can to give the best pos-

sible chance for that to be achieved. But it is a heavy lift, and if we do not achieve those objectives, then the long-term prognosis is not going to be as good as you have presented.

Second, it depends upon an effective strategy to deal with this economic crisis, and let me talk about that, for a moment.

We have heard over and over again that the economic engine of America in creating new jobs is small business. That is where most jobs are located, and where most of the job growth will take place. That is where we find the best prospects for innovation in America.

Now, before President Obama was inaugurated as President of the United States, Larry Summers made a commitment that we would have a strong program to help small businesses. I have asked questions at hearings before as to when are we going to start to see small businesses get the help that they need. There was a commitment to use the Federal Government in the secondary markets to ease up SBA loans. You have said that you are going to become out with a program to help small businesses.

I was concerned by Assistant Secretary Neel Kashkari's comments yesterday where he said that government is not going to interfere with the banks' lending policies; it is going to be up to their independent judgment.

Can you tell me specifically when small businesses in Maryland and around the Nation can get some help from these programs? They do not see it today.

Secretary GEITHNER. Very important. Very important objective, and I completely share your commitment for us moving aggressively to fix this.

Now, let us just start with in the stimulus package there is a range of very important provisions for small businesses, including a substantial increase in the SBA guarantee program. To make that work fully effectively, we need to make sure that these lending programs we announced 2 weeks ago are also up and running operationally, and they are coming onstream very, very quickly. That will help make sure there is liquidity available to help support those issuance. But that is not enough.

We also need to make sure that community banks are getting access to capital where they need so as quickly as possible, and we are committed to doing that. And as I said, as one of your colleagues said earlier, it is very important that supervisors are working in support of this objective, not against it. And we are looking at other ways and are open to suggestions on other things we can do quickly to help reinforce these big objectives.

But you are absolutely right that getting credit available to small businesses who are viable, can support strong businesses, is an absolutely critically important priority. And you have seen a lot in stimulus and recovery. You see additional things in the budget which we hope will pass quickly. And you will see—we have already started these lending programs that are necessary for the SBA program to work.

Senator CARDIN. I know the tools are there. We just have not seen the results.

Secretary GEITHNER. Right.

Senator CARDIN. I can tell you, I meet with the small business people in my State frequently, and the credit sitution for them is just as tough as it was 4 months ago.

Secretary GEITHNER. I agree with that.

Senator CARDIN. I would urge you, first of all, to keep us informed as to what is happening, what the facts are.

Secretary GEITHNER. Yes.

Senator CARDIN. And, second, do some visible things to show that you are concerned about small businesses. We need their help, and they really do believe government aid is primarly directed at large corporations, and that if you are smaller, there is no help available.

Secretary GEITHNER. I understand that concern, and we are very committed to fix this, we are moving very aggressively, and we will give as much prominence and profile to these initiatives as we can.

Senator CARDIN. I appreciate that.

Let me just talk for a moment about these toxic assets, because I am not exactly sure I understand the mechanism that you have in place. Are you trying to get them sold and off the books of these banks that are not as healthy as they should be——

Secretary GEITHNER. Yes.

Senator CARDIN [continuing]. Or are you trying to get just a better valuation, you are trying to get them off the books? So you are going to have a private-public partnership to have investors purchase these assets?

Secretary GEITHNER. To provide an opportunity for them to sell these assets.

Senator CARDIN. And then a private entity would own the toxic asset, and the bank would get the——

Secretary GEITHNER. Sharing the upside with the Government, managed by people who are good at managing these assets.

Senator CARDIN. And are the specifics of this proposal now well——

Secretary GEITHNER. No. We are outlining within the next couple of weeks the details of these proposals so everybody can see them and see how they are going to operate.

Senator CARDIN. As you know, predictability is important——

Secretary GEITHNER. Very important.

Senator CARDIN [continuing]. In all of our businesses, and there is a lot of speculation out there as to how much risk the private investors are going to have to take and whether this plan is viable or not. I urge you to have transparency as this is developed, because there are some good ideas out there, and there is a lot of money sitting on the sidelines. Investors are prepared to make investments if they believe that this is going to be a fair process. And I could not agree with you more, we have got to get these toxic assets off of those banks' balance sheets; they are recluding banks from making loans today.

Secretary GEITHNER. Yes, and you are absolutely right that it has to come with absolutely clear, full transparency for people to have confidence in the program.

Senator CARDIN. Finaly, I want to underscore the urgency of the real estate situation. February's foreclosure numbers were shocking. We have got to stop the hemorrhaging of people losing their homes, and I would just underscore that point.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you. And Senator, you get a prize. You were right on time. What a good example.

Senator CRAPO.

Senator CRAPO. Thank you very much, Mr. Chairman. And, Secretary Geithner, thank you for coming today. I want to try to make three or four points during my 6 minutes, so I will try to talk fast.

First, could we put the chart up on the deficits?

I want to return to one of the issues that Senator Gregg raised with you, and that is just the question of where we are headed with our deficits in the country. With the chart that we have up there, I want to focus on the blue line first. The blue line is, as I understand it, what CBO's assessment is of the baseline; in other words, what would happen with our deficits if we simply follow current law and do not do anything different for the next 5 years or so.

What that line shows is that if we just followed the current law, our deficits by 2012 would be down in the $200 billion range and declining over time. And it shows with regard to the President's budget that although there are some spikes—and I understand those spikes as a result of, I assume, the stimulus act and some of the other things that we have been doing—it also declines rapidly basically as a result, as I understand, the way that we will be phasing out the excessive spending and the stimulative actions and the TARP funding and so forth that we are engaged with right now.

My point is, first at least, to make the comparison between the two lines, but to make this point: When the President says he wants to reduce the deficit by half by 2012, isn't he basically saying that—I mean, that is going to happen anyway as a result of current law. That is not correct?

Secretary GEITHNER. Well, Senator, this is very important to point out. That blue line, for that to happen, you would have to have no extension of the AMT; you would have to have—taxes on 95 percent of Americans would rise substantially. There would have to be, I think, no foreign wars. It would be peace and prosperity across the world tomorrow. And so it is not actually anything like a realistic expectation about what is a sensible economic path for the country.

Senator CRAPO. I understand that, and leaving out the potential for another war, I am one of those who, I am sure you know, does not believe we should let the tax cuts expire and that we should maintain our current tax policy. And my understanding is that if we did maintain tax policy and did not have tax increases on the American public, that line would be somewhere between these two lines.

But my point still is, shouldn't we—and, again, I am not trying to make the comparison between the two lines. Others can make that point. I think it is maybe a valid point to argue about. But my point is this: As we talk about trying to reduce the deficit, admitting that we need to do something on tax policy—and we may disagree on that; we do agree on the AMT—shouldn't we try to do much more than simply allow our current trends to take us back to a much smaller deficit? In other words, shouldn't we be much

more aggressive on deficit reduction than simply allowing the trend lines to bring us back to a normal reduction in about half of what we have?

Secretary GEITHNER. I want to just underscore this. It is absolutely imperative that we lay out a path that brings us back to sustainability, and that requires more than just letting the temporary increases in spending in the Recovery Act expire and fall—it requires more action by the Government and the Congress to do that. And the President's budget proposes a number of specific measures necessary to bring that deficit down to 3 percent of GDP over time. It is not enough just to sit back and let those temporary things expire. You have to do more things.

But it is very important to recognize the tax increases that are proposed in this budget, again, only come when recovery is in place, and they only go into effect on a small fraction of the most affluent Americans, very limited number of small businesses, and only restore those rates, again, to a level that prevailed during a period where you had remarkably strong——

Senator CRAPO. You just got to my second point that I wanted to make, and that is, you say that the tax increases will only happen when the economy has recovered. I understand that a lot of economists are saying we are going to be recovered by 2011. Frankly, I think there are economists who are saying that maybe our recovery will not be so strong by then.

My question to you is: Are these tax increases contingent on a recovery? Or are they going to happen regardless of what happens in 2011?

Secretary GEITHNER. Senator, I think it is a very important question. I think that, again, we need to lay out an ambitious path for bringing those deficits down; commit to achieving that, with a mix of measures on the resource side and the spending side that do the best possible job of leaving our economy stronger. And that is what the President's budget tries to do.

Now, of course, we are going to have to watch how the economy evolves, and I want to underscore that one of mistakes governments have made over time in dealing with economic crises is putting the brakes on too quickly or in ways that, you know, hurt growth just as it is starting to take——

Senator CRAPO. So are you saying——

Secretary GEITHNER. We want to be careful not to do that.

Senator CRAPO. So are you saying that if we do not see the more rosy picture in 2011 that we may not see the administration suggest that we——

Secretary GEITHNER. No, I am just saying——

Senator CRAPO [continuing]. Tax increases?

Secretary GEITHNER. I am just saying that recovery requires that we keep stimulus sustained until growth is in place, but we have to do it in a fiscally responsible way.

Senator CRAPO. But what about the tax policy? Are you including tax policy in that?

Secretary GEITHNER. Again, I would say generally. Of course, we have got to keep watching things as they develop, but what we need to do together is lay out a path that brings those deficits

down, and we have to agree on what the right mix of measures on the resource side and the expenditure side are to do that.

Now, we are going to have slightly different priorities in that context, but I believe that this is the best package of policies to leave our economy stronger in the future, and I think, again, if you look at the record, just going back to the second half of the 1990's, there is a pretty strong empirical—very strong empirical case that that produced a level of private investment and productivity growth that is the envy of the world.

Senator CRAPO. Well, I ran out of time, and I only got to two points, so I will——

Secretary GEITHNER. I apologize, Senator.

Chairman CONRAD. I thank the Senator. He gets a prize as well.

Senator Sanders.

Senator SANDERS. Thank you, Mr. Chairman. Welcome, Mr. Secretary.

Mr. Secretary, as you well know there is a huge sense of outrage in our country with what Wall Street has done through their greed, through their recklessness, and perhaps their illegal behavior, in plunging us into this deep recession and bringing us to the cusp of a depression, all of which has impacted tens and tens and millions of people, hurt so many people.

I want to express my view that I am concerned that the same people on Wall Street who were part of the problem are still in office, and they still have all of the power and all of the money that they used to. I am concerned there has not been a serious investigation explaining to the American people who caused this crisis. I have not seen the kind of prosecutions that I think should be done.

So I would hope from the Treasury Department we will begin to give confidence to the American people—you know, they talk about Wall Street wanting confidence from you. The question is the American people have no confidence in Wall Street. So I would hope that we would see a more aggressive posture on the part of the Treasury Department and express it, the outrage that the American people feel about the greed on Wall Street.

Now, of the many issues that all of us hear about, one of them that I hear a whole lot about is that at a time when the taxpayers of this country are providing hundreds of billions of dollars to bail out Wall Street, Wall Street is saying: Thank you. We are going to charge you 15, 20, 25, 30 percent interest rates on the credit cards that we are issuing to you.

That is very nice of those guys. We are bailing them out. They are getting zero-interest loans from the Fed, and then they charge our people 25 or 30 percent interest.

I am introducing today legislation that would cap interest rates in this country at 15 percent, cosponsored by Senator Durbin. It emulates actually what the Federal Credit Union Act does for credit unions. Many people do not know this, but credit unions cannot charge more than 15-percent interest rates, with certain exceptions, then go up to 18 percent. Credit unions are not coming in here to be bailed out.

So my question is: Do you think it is time in this country for legislation to cap interest rates—to go back maybe to where the Bible

took us, that says it is immoral for financial institutions to charge middle-class people 25, 30 percent? Would you support a cap on interest rates?

Secretary GEITHNER. Senator, I want to begin by saying I completely share your sense of basic outrage and anger. I understand how powerful it is across the country. You are absolutely right that the judgments made by the leaders of our financial institutions have caused a catastrophic loss of basic confidence. It is making everything worse—everything we need to do to get recovery back on track is made worse by those basic judgments. I could not feel more strongly about this issue, and that is why the things we do have to be directed at making sure that we are getting more credit to the American people, not less.

Now, on your specific—I would like to look at your proposal in detail and give you a more thoughtful response. The basic test that we would have to apply to any proposal like that is, again: Is it going to make it more likely that credit is available on reasonable terms or less likely? That is the basic balance we have to strike. But I would be happy to take a careful look at your——

Senator SANDERS. Mr. Secretary, all I would say is that this concept has been in existence under the National Credit Union Administration. Our credit unions are doing pretty well. They are lending out money to people who need it. They are not asking for bailouts of hundreds of billions. I think we should emulate what they are doing.

Second point. You have raised with AIG, all of us know, this absurd concept of "too big to fail." What I have said from the very beginning of this crisis is that if an institution is too big to fail, it is too big to exist.

What are we doing now to break down and break up these organizations so that we are never again placed in a position to have to bail them out because of the systemic damage that would occur if they failed? Are we starting right now an investigation to say, Sorry, Bank of America, sorry, Citigroup, sorry, AIGs of the world, we no longer can sustain institutions that are just so large that it could cause so much damage if they failed?

Secretary GEITHNER. Senator, you are absolutely right that we have to create a system that is less vulnerable to the kind of risk we see in this crisis, and part of that is going to require that we have much stronger oversight with much greater constraints on institutions that pose some potential damage to the system. And a critical priority of the President, working with the Congress, will be to put in place legislation which will achieve that objective.

Now, right now, as you know, the Government's assistance in AIG is conditioned under there being a very dramatic, substantial restructuring of that entity. And where we have to—if we have to take additional actions to help stabilize the system, we will make sure that those actions come with conditions that achieve——

Senator SANDERS. OK. Very briefly. We do not have much time here. You know, I voted against the repeal of Glass-Steagall. I argued with Greenspan every time he came before the House Financial Institutions Committee. I do not believe in unregulated financial institutions, et cetera. But on this key issue of "too big to fail," I think we have got to go back to where Teddy Roosevelt was—do

you agree?—and start saying, Sorry, we are going to break them up.

Secretary GEITHNER. I completely agree that we do not want to put this country in the position in the future where we are vulnerable again, where the weakness in one institution causes the risk of great damage to the fabric of the American financial system. That basic objective has to underpin everything we do in the reform agenda, and we have to get it right.

Senator SANDERS. OK. Thank you, Mr. Chairman.

Chairman CONRAD. I thank the Senator.

Senator SANDERS. And I am giving you back 17 seconds. Do I get some credit for that?

Chairman CONRAD. You are rising to a whole new position.

[Laughter.]

Chairman CONRAD. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Do you support a biblically based 10-percent flat tax?

[Laughter.]

Secretary GEITHNER. I do not like to——

Senator GRAHAM. You do not have to answer that.

Chairman CONRAD. You do not have to answer.

Senator GRAHAM. Well, do you support a temporary suspension of the mark-to-market rule?

Secretary GEITHNER. Senator, that is the prerogative of the SEC. I want to say one basic thing, which is that we are at a period where investors do not have a lot of confidence in their capacity to judge the risks——

Senator GRAHAM. From your personal point of view, is it a good idea or a bad idea?

Secretary GEITHNER. My personal point of view is that we have to be very careful not to do things that would erode confidence in the people's ability to assess the risks and exposure to a bank.

Senator GRAHAM. OK. Well, let us look at—and you think that might do that.

Secretary GEITHNER. There are some versions of those proposals that would have that risk, and like many things, these are complicated, careful judgments. But I know that my colleague Chairman Schapiro is looking carefully, as she should be, at all reasonable proposals.

Senator GRAHAM. OK. Let us look at some assumptions that are being made in this budget process and about the economy in general. Under President Obama's budget, he assumes a 3.2-percent GDP growth in 2010. Do you think that is accurate?

Secretary GEITHNER. I think that is a reasonable judgment based on the evidence available when the budget was put together.

Senator GRAHAM. Do you think that is a reasonable judgment now?

Secretary GEITHNER. I do think it is a reasonable judgment, but as you know, that is the kind of judgment we have to assess carefully. There is an established rhythm——

Senator GRAHAM. Would you like to change that judgment?

Secretary GEITHNER. Not today I would not.

Senator GRAHAM. OK. The assumption also is made that unemployment would peak at 8.1 percent in 2009. Do you stand by that assumption?

Secretary GEITHNER. Senator, I will just say again—I mean I know what you are asking, and——

Senator GRAHAM. It is a simple question.

Secretary GEITHNER. Again, as I said, that forecast, done with independence and integrity, always underpins——

Senator GRAHAM. Given what you know today, do you think that is a reasonable assumption to make?

Secretary GEITHNER. Senator, I still believe, if you look at the consensus of private forecasts, they project recovery starting to take hold the latter part of this year into next year.

Senator GRAHAM. Let us try this again. Do you believe that the assumption that unemployment will peak in this Nation at 8.1 percent in 2009 is still reasonable?

Secretary GEITHNER. Senator, I am going to say it exactly the same——

Senator GRAHAM. Fair enough. We will move on.

Secretary GEITHNER. OK.

Senator GRAHAM. Do you believe that if we put limitations on charitable giving where the maximum deduction would be 28 percent versus what it would be today, 35 percent—the Independent Tax Policy Council has estimated that $9 billion would be lost in terms of charitable giving. Do you agree with their assumption or ont?

Secretary GEITHNER. You know, I will have to look more carefully at it, but as we have said before—and I think this is true in independent estimates—those proposals, again, which would only take place if we agree on comprehensive health care reform in years out there, would affect a very small fraction of——

Senator GRAHAM. It is just the concept that I am trying to drive at, that if we begin to limit the charitable deduction write-off, does it have an adverse impact on charities?

Secretary GEITHNER. You know, Senator, it depends, as you know, on what else is happening, and the most important thing you can do to affect charitable giving is to get this economy back on track and a stronger basic position.

Senator GRAHAM. I think the most important thing you can do is to reward it when it is done. That is just my assumption.

Let us move on now to the stress test. And, No. 1, thank you for taking the job. I know it is tough, and you are doing a lot of things, and I agree with Chairman Gregg that this is not easy and you do not have your team in place. And if you are looking for a way to serve the country, join the marines or go to Treasury. I think they are both very difficult.

Secretary GEITHNER. I am very glad you said that, and I completely agree.

Senator GRAHAM. Very difficult assignments.

Secretary GEITHNER. No more important, no more noble opportunity.

Senator GRAHAM. The few, the proud, the brave—the Treasury people, yes.

[Laughter.]

Senator GRAHAM. But—where was I at? Oh, OK.

Secretary GEITHNER. I just do not want to say "the few." We want to say "the many and the proud and the brave."

Senator GRAHAM. That is right. The bottom line about the stress test is that we are going to put some of these banks under stress and see if they are adequately capitalized. That is the goal, right.

Secretary GEITHNER. Yes. I am not sure the word "stress" is the best used in this context. Again——

Senator GRAHAM. Well, that is what you all call it.

Secretary GEITHNER. Well, that is the sort of standard term of art. Remember, every institution——

Senator GRAHAM. Well, whatever you are doing, you are trying to find out if in some reasonable scenarios banks are adequately capitalized. To me, that is a good thing. You are doing that, right.

Secretary GEITHNER. That is the objective, yes.

Senator GRAHAM. You are testing these banks.

Secretary GEITHNER. Yes.

Senator GRAHAM. To determine adequate capitalization, is it the Tier 1 regulatory standard you will be using?

Secretary GEITHNER. We are leaving the regulatory standards in place, but as you know, what matters is not just the amount of capital you have, but the quality of that capital.

Senator GRAHAM. Sure, that is the risk, but what will you be using to judge adequate capitalization?

Secretary GEITHNER. We are going to look at the existing regulatory requirements both in terms of the overall amount and the quality of capital, meaning how much of——

Senator GRAHAM. Will it be the Tier 1 system?

Secretary GEITHNER. Yes, the existing framework will remain place.

Senator GRAHAM. OK.

Secretary GEITHNER. What matters is to look forward at what might happen in a more adverse recession.

Senator GRAHAM. OK. If the Government owns 36 percent of common stock of a company, a bank called Citibank, and virtually makes every decision or has every decision of that bank run by the Government, what would you call that?

Secretary GEITHNER. Senator, that is not the case today, although under the proposal that they presented to their private investors and the Treasury, that would happen. But I want to underscore this——

Senator GRAHAM. Is that free market?

Secretary GEITHNER. I would say that we are going to do what is necessary in the interest of the American financial system to make sure——

Senator GRAHAM. OK. I have got 18 seconds left. Are you assuming a TARP III would pass this Congress to put new capital into banks?

Secretary GEITHNER. You know, my operating assumption, Senator, is that there is widespread recognition across the country that getting the financial system back to the point where it recovers and provides credit is a critical——

Senator GRAHAM. Do you think TARP III will pass this Congress if you made a request?

Secretary GEITHNER. Our hope is that the Congress will come together and do what is necessary to make sure the financial system is strong enough.

Chairman CONRAD. Thank you, Senator.

Senator MURRAY.

Senator MURRAY. Thank you, Mr. Chairman, and Happy Birthday to you. I cannot think of anybody else who would rather spend their birthday chairing a Budget Committee hearing.

[Laughter.]

Senator MURRAY. Welcome, Mr. Secretary. I have a couple of questions relating to Bank of America and Merrill Lynch. Both of those firms have received TARP money, correct?

Secretary GEITHNER. Yes.

Senator MURRAY. All right. And do you know how much it is?

Secretary GEITHNER. Senator, I would be happy to get back to you with the specific numbers, but it is a lot of money.

Senator MURRAY. In the hundreds of billions.

Secretary GEITHNER. No.

Senator MURRAY. More than $150 billion.

Secretary GEITHNER. For Bank of America and——

Senator MURRAY. And Merrill Lynch.

Secretary GEITHNER. No.

Senator MURRAY. Including guarantees, debt guarantees?

Secretary GEITHNER. But the right—I mean, again, people have different assessments. What we want to look at is the risk and exposure to the Government in that context. And I do not think that is quite the right way to measure. But I would happy to provide a detailed assessment of——

Senator MURRAY. OK, if you could. But it is a substantial amount of money.

Secretary GEITHNER. It is a very substantial amount of money.

Senator MURRAY. And that was necessary because we needed to make sure we were stabilizing the industry. I understand that.

Secretary GEITHNER. That is right.

Senator MURRAY. OK. And Bank of America recently formalized the acquisition of Merrill Lynch in January, correct?

Secretary GEITHNER. That is correct. Now, Senator, I just want to say one thing. I am the Secretary of the Treasury.

Senator MURRAY. Yes.

Secretary GEITHNER. I am not in and nor would my predecessors have been in the position of responding to detailed questions about individual institutions given the basic constraints in which we all operate. But I would be happy to be as responsive as I could. But I want to just give you that one caution——

Senator MURRAY. I appreciate it. Where I am going with this is they have received a large amount of money from the Federal Government at this point.

Secretary GEITHNER. A very substantial amount.

Senator MURRAY. Correct. And have they been profitable since they received that money?

Secretary GEITHNER. Again, that is not a judgment I can make or share with you today, although I think you will see in the public domain, in the context of the normal reporting period, a full answer to that question, like you will for institutions across the country.

Senator MURRAY. Well, OK. Let me just ask you, do you think it is appropriate given the financial condition of these firms—and I assume that there are losses—that bonuses were paid to their executives?

Secretary GEITHNER. Senator, I find it deeply offensive what happened in compensation practices across this country, and then the role that played in contributing to this crisis. And I think it has made it much worse, that even as the crisis intensified and the Government was forced to do extraordinary things, that you saw some institutions making really terrible judgments about how to reward their executives, even as their institutions were facing extraordinary losses.

And as you know, the President proposed some very far-reaching, substantial reforms and some conditions that could come with assistance. In the stimulus bill, an additional set of restrictions or conditions were passed, and we are in the process and have the obligation now to try to translate those requirements and proposals into detailed guidelines, and we are working on it.

Senator MURRAY. OK. I appreciate that, because my constituents are hurting. Families and businesses are really struggling, and they do not understand at all the fact that some of these companies are having lavish weekends and paying out bonuses and all of that. So we know they are going to need additional capital, and I heard what you just said, that we are going to make sure that that is accountable. And we do not see this, but money is fungible. So how are we going to assure that taxpayer dollars are used not for lavish weekends or bonuses or these things that seem so out of line to ordinary citizens who are trying to pay their bills?

Secretary GEITHNER. Assistance comes with conditions. It is not a right. It is a privilege. Those conditions will require that banks use the resources we provide them to increase the amount of lending that would otherwise have been possible; that they report on what is happening in lending in a way that is transparent and accessible to the American people; that our assistance comes with appropriately tough conditions on compensation to senior executives that is going to, you know, incent what we need to happen and make sure that taxpayer dollars are not going to benefit those senior executives in ways that do not make sense.

Those are our basic objectives, and I completely share your concern about it, understanding how strong these opinions are across the country.

Senator MURRAY. OK. I appreciate that, and I think it is really important that we continue to send that message and hold them accountable.

Let me quickly flip to another question, and that is the impact of declining trade and exports. The Department of Commerce issued a revised GDP number for the fourth quarter of last year that showed that overall economic contraction was a lot more severe than originally projected. I have seen the minutes from the Federal Open Market Committee, their January meeting. It showed a consensus view among the participants that the declining global consumption abroad was a key contributing factor to declining exports and GDP.

Can you tell us with this interdependent global economy what the impact is of this, what we need other countries to be doing, not just ourselves, and how we are going to achieve that?

Secretary GEITHNER. Thank you very much for raising that. It is very important to understand that our fortunes are closely tied, much more so than at any other time in our history, with those of the rest of the world. And it is very important that all the major countries are moving together to strengthen demand, lay the foundation for recovery, that they are moving aggressively to fix their financial systems. And we need to make sure that the international financial institutions that provide great leverage on American assistance are using those resources to help those emerging market economies that are critical markets for U.S. exports get back on track more quickly. And we are going to work very aggressively. The President is going to take a very active leadership role with the G20 to try to make sure that we are all making a sustained commitment to recovery. And we are providing assistance to make sure that those critical markets have a stronger foundation.

Senator MURRAY. I think that is so important. We have to understand that this is having a huge impact, so I am——

Secretary GEITHNER. You are absolutely right.

Senator MURRAY. And I am extremely concerned about some of our countries in Central and Eastern Europe who are seeing increasing financial instability. Can you talk a little bit about that region of the world and the impact on us as——

Secretary GEITHNER. You are absolutely right. They are facing a set of challenges far more acute than is true in many other parts of the world, and it is just a symptom of how complicated and severe this crisis is.

You know, a lot of people understand what happened in the United States, and it did start earlier in the United States. But many of the challenges in financial systems and their economies are much greater outside the United States, and it is going to require a lot of cooperative efforts to help them get through that process.

Senator MURRAY. Particularly since our U.S. banks have invested in many of those countries, so a longer conversation, but I hope that we can address that in the future.

Thank you, Mr. Chairman.

Chairman CONRAD. Senator Alexander.

Senator ALEXANDER. Thank you, Mr. Chairman.

Mr. Secretary, thank you for being here, for your good humor and your resilience in all of this. I would like to shift gears a little bit in terms of a conversation with you, which I hope provides a constructive suggestion. I wonder if you are familiar with a book that Professor Ernest May at the Kennedy School at Harvard wrote called "Thinking in Time: The Uses of History for Decision Makers."

Secretary GEITHNER. I am not familiar with that book, but it sounds like I should be.

Senator ALEXANDER. Well, it is an interesting book. It tries to compare, as you face decisions to make, if there are analogous decisions in the past that would illuminate anything. For example, if you are dealing with the Cuban missile crisis, is it analogous to

look at Hitler coming into the Rhineland, or is it not? And I wanted to suggest a couple of examples in our history and ask you whether they suggest anything to us about how we might deal with what you have talked about today, which is fixing the banks and getting credit flowing again as our major challenge.

One is the bank holiday that FDR had when he was elected to office in March 1933. Two days after taking office, he declared a bank holiday that lasted 4 days. He closed the banks. He let certain ones open. There was a bigger crisis then with banks—5,000 banks went out of business. There were different rules at the time. He had a fireside chat. By the beginning of April, Americans were confidently returning a billion dollars to the banking system. According to this report, the bank crisis was over. That would be one example.

What I think might be a little more analogous is President Eisenhower in October 1952 and his view on Korea. I am going to read just a paragraph from his speech, because it sounds like today a little bit to me. He says, "The first task of a new administration will be to review and re-examine every course of action open to us with one goal and view: To bring"—in this case—"the Korean war to an early and honorable end....The reason for this is simple. The old administration cannot be expected to repair what it failed to prevent."

It sounds familiar to me.

"Where will a new administration begin? It will begin with its President taking a simple, firm resolution. The resolution will be: To forego the diversions of politics and to concentrate on the job of ending the Korean war—until that job is honorably done....I shall make that trip....I shall go to Korea."

One of the most memorable lines in American history.

Now, here is my suggestion: I believe that the American people—I know that I am—are persuaded that our new President is impressive, intelligent, and having watched his campaign and watched his first few days in office, I am absolutely convinced he can do many things at once and do many things well.

I am also convinced he does not need to scare the American people anymore. They are scared enough in Tennessee about what is going on and the President does not need to explain the problem with banking and credit anymore. Most people understand the problem.

I wonder whether President Obama needs to borrow a lesson from President Eisenhower in 1952 and simply say, as you announce your new plan for banking and credit next week, "I will fix the banks, and I will get credit flowing again, and I will make everything else second and subordinate until that job is honorably done. I will put the Health Summit aside, the Fiscal Responsibility Summit aside, the education challenge, the energy challenge"—all those other challenges are important, but in an Eisenhower sort of way, should he not say, "I will fix the banks, I will get the credit flowing again, and I will concentrate on that job until it is honorably done"? Otherwise, how will he regain the confidence of the American people for that one solution?

Secretary GEITHNER. Senator, very important to say in the beginning—and the President has said this, and he will keep saying it—

that our central obligation to the American people is to do what is necessary to get this economy on track, back on track, and to keep at it until we achieve that. And a necessary condition for that is to fix this financial system and get credit flowing again, and we will do what is necessary to achieve that outcome.

Now, you cannot do it just by focusing on the financial system. You have to make sure the Government is providing very, very substantial support for demand. That is a necessary way of doing it. And there will be other things like you are seeing us do in housing that are part of that solution.

Now, you are absolutely right, that is the central, most critical priority for our country, and the important message that he has said—and we are committed to do it—is that we will keep at it until we fix it. But we have a lot of challenges as a country, and just like it is so important, as many of your colleagues have said, that as we try to get recovery back on track, we are making it clear we are going to get us back to fiscal sustainability, we need to give American people the confidence that we are going to start to fix—start today to fix these long-term problems that have been neglected, frankly, and are going to be really important to making sure our economy can grow, too.

Senator ALEXANDER. I have just a few seconds left, and I respect what you are saying, and I am not unimpressed with our President or with you and your abilities. I am simply saying from my vantage point and looking at the example of FDR in the banking crisis in 1933—he had that fixed in 3 weeks. And he did not do the TVA and the CCC and the WPA and the PWA and all the other things until after he had the banking part of that crisis fixed. And Eisenhower focused on one job, "I shall go to Korea." And he went to Korea on November 29th of 1952, within a few days of his being elected.

I guess what I am saying is that part of the President's job is to see the strategy and let the country know about it, but he needs to persuade at least half the people he is right about it. And if you do have a plan, you have not persuaded us yet. And until you persuade us, confidence will not come back.

Secretary GEITHNER. Senator, maybe I could just end by making one very important point. If you look at the lessons of history and the lessons of financial crises, the most important thing is how quickly it is—to move together quickly, comprehensively, and not to wait and not to be too tentative. And that basic lesson, which is in the American experience, the experience of Japan, and many other countries, shapes everything we do. And you are right to invoke history in that context, and I completely share that basic comparative.

Senator ALEXANDER. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator.

Senator WHITEHOUSE.

Senator WHITEHOUSE. Thank you, Mr. Chairman, and thank you, Mr. Secretary. I know it has been a long morning, and I appreciate that you are here and have worked so hard to help solve these problems.

The first thing I want to compliment you on is the directional changes in this budget. We spend an awful lot of time fighting around here about budget issues that are the equivalent of who gets to use the lighter first in the car and what belongs in the glove box. And you focused on where we are going and what have we have in front of us, particularly with our energy policies, which have been self-defeating and largely dictated by big oil companies. Now we have the prospect of a new energy policy that serves the American people; education, equally self-defeating policies that have led us to decline in our status in international competition, which is really shameful for a country like ours that has the best educational institutions in the world; and most particularly, health care, which, as a former Comptroller General has said, "threatens to swamp the ship of state." We have to address these things, and for the first time, at least in my time here, this budget responsibly tries to do that. That I think is the key, overarching point that we should all think of.

Some of the fine aspects of it, I also compliment you on the change to the outrageous tax loophole that allowed hedge fund barons to pay a lower tax rate than the guy loading the luggage into their private jets would pay. It was just, frankly, a disgrace to the country, and this cleans that up and I appreciate it.

A couple of specific questions, though. You talked about your outrage about the compensation practices that pre-existed this crisis and, in an exercise in very bad taste and bad judgment, actually continued into the crisis.

As you know, I have a concern about mummified compensation practices that took place during the Gold Dust era when people were laying it on thick, and I think it was even pretty disgraceful then. But they got locked in because people created tax dodges and did deferred compensation, or they got special, you know—like the old James Bond movies where the bad guy gets to get away and everybody else in the boat goes into the hole, and he has got his escape pod. They had their escape pod—health care packages, retirement packages that were different than their employees.

A lot of that stuff is now embedded, and under our legal system, which I fully support, it requires a hearing of some kind before you can even address that question. Because these institutions cannot go into bankruptcy because of the systemic problem, that eliminates the only present way to get that hearing to do anything about the mummified costs. And, you know, the mummy is going to walk at some point, and it is going to be really embarrassing, I think, to have $40 billion, as the Wall Street Journal reported, of taxpayer money go to pay deferred executive compensation that has been mummified on the books of these companies when people are suffering as badly as they are.

I would urge you to take a look at working on a way to try to solve that problem. I think it will emerge as a serious one, and I have a proposal, as you know. Now may not be the moment for it, but I really do think that this is a problem that has to emerged.

The second thing I would like to direct your attention to, we had a real nightmare in Rhode Island, a banking crisis, about 15 years ago. It was a small but very intense situation, and people were very, very angry. One of the things that helped a great deal was

an investigative commission that Governor Sundlun then put together to take a look at what had gone wrong, to bring people before the public. One of the members is now a district judge, a United States district judge. Others have gone on to—it was a very distinguished group of people. They did a very credible job, and it really helped people understand what was going on.

There is no present mechanism for anybody to understand what took place, and particularly when so much of the money is going back to the people who seem to cause it, I think it is important that we work on a strategy to really draw out and explain to the American public what went wrong and why this will not be repeated.

I know that as you are going through the fixes, that is an incidental, and an important incidental, but I think somewhere it should be somebody's first order of business to bring people in, take some testimony, and sort that out.

Those are just two points I leave with you. The question is this: Back to what Senator Sanders was asking about, credit card rates, many years ago the Supreme Court decided the Marquette decision, which was a technical decision about who had jurisdiction when you had a bank in one State and a consumer in the other. And the Supreme Court resolved it in favor of the bank's State.

Well, then economic development folks came along and they figured out, wait a minute, if we can trash our banking laws, then we can attract banks who then are operating without any real restriction on them. And that has been the status quo since then.

It does not seem to have been a very deliberate policy choice. Is that status quo presently important to our economic recovery in any respect?

Secretary GEITHNER. Senator, I want to say something that I believe—I think is responsive to your question, but let me say it this way: One of the problems in our financial system is that we let many financial institutions choose their regulator.

Senator WHITEHOUSE. Yes.

Secretary GEITHNER. We let people structure a product to take advantage of the optimal mix of tax accounting, regulatory capital treatment. We provided huge opportunities for arbitrage, and that lowered the overall quality of regulation, undermining the basic public policy objectives regulations are designed to address. And one of the most important things we need to do as we reform our system is to address and end and change the basic judgment that that kind of competition produces acceptable outcomes for public policy.

So I agree with your concern, and we share an obligation with you to fix that as we reform the system. And I just want to underscore what you said, because I think you are right that, you know, sort of a test of credibility is the ability to look back honestly, independent judgment about what exactly caused this crisis, and that will provide the necessary foundation for us in figuring out how to fix it going forward, and the process that the Banking Committees and other committees are working through in the Senate and the House will begin the process of bringing in a whole range of outside experts to contribute testimony and analysis to that assessment. But it is a critically important thing to do and a test of the credi-

bility of any country, and we are generally good at that, at doing that as a country.

Chairman CONRAD. Thank you, Senator.

Senator MERKLEY.

Senator MERKLEY. Thank you very much, Mr. Chair, and I certainly applaud the administration on putting forward a budget that seeks to address the incredible mess created over the last 8 years and to reposition America in terms of energy and education and health care to be much more successful down the road.

I wanted to ask a couple questions as we go about that task, and one is—and I am referring to an article—David Smick wrote an op-ed a couple days ago in the Washington Post, and he noted one of the challenges we face—and it certainly would seem relevant to the public-private partnership goal of removing toxic assets from the banking system—is that the assets are worth, if you will, in a market sense 5 to 30 cents, but that to make the banks stable and successful, one would need to pay 50 to 60 cents. That is quite a gap, and how does one attract a private partnership into that kind of scenario where they might need to pay far more than the assets are worth? And how does one go about tackling that? I recognize this is an inherent dilemma you are working night and day to figure out.

Secretary GEITHNER. Well, you are right about the problem, and the challenge is to try to make sure that with Government financing—which financing is not available in these markets now—to provide a market clearing mechanism for these assets. And our judgment is that, again, we can provide some Government capital and some Government financing, that you are going to provide something that does not now exist, which is a way for this to start get clearing.

Now, again, what is sort of burdening the system now is the fact that there is really no financing available, no market for these assets, and, therefore, no real ability for banks that need to get rid of these things and do so in a way that is sort of sensible and effectively. But then this plan will address that.

I would not agree, though, with the precise example that you used in terms of about what the price is of this and what is necessary to achieve this. But what we need to do is to get those market prices up again by making financing available. You want to make sure banks have a greater incentive to get rid of those assets.

Senator MERKLEY. If I understand your point, to some degree the lower market valuation now is the result of the lack of demand, which is driven by the lack of credit to drive or clear the market. Is that a fair way to put it?

Secretary GEITHNER. Again, that is a key thing. Just to take the mortgage example as a simple example, if you had to sell your house tomorrow—not in 3 years, not after your kids go to college, but tomorrow, and nobody could get a mortgage, the price you would get would bear no realistic resemblance to what you might get in a normal condition. That is a simple explanation of what you are seeing across markets.

And so providing the financing is a necessary—not a fully sufficient condition to do that. You know, the things that are driving uncertainty about the valuations is partly just concern about how

deep the recession is and uncertainty about what the losses might be in that context. But a big part of this is the absence of financing.

Senator MERKLEY. A second issue that has been raised is whether bank bond holders, should participate in the pain, and on the positive side, that that participation is appropriate given the risk associated with their investment and the current status of the banks; and the opposite side, as I understand it, is that if the bond holders take a haircut, that it might decrease investment in other commercial or corporate bonds, damaging our effort to restore liquidity.

How do you see that balance in how we approach this?

Secretary GEITHNER. It is not a close call, Senator. It is necessary to protect the financial system and get recovery back on track for the markets to understand that we will do what is necessary to make sure that these major institutions can meet their commitments. And everything we are doing in terms of making capital available where it is necessary, providing support in terms of liquidity, funding, and guarantees, is to underscore that commitment to make sure these institutions can meet their commitments. That is necessary for them to be in a position to help provide the credit necessary for recovery, and that objective has to guide everything we do.

Senator MERKLEY. I appreciate your analysis. It is a little difficult to explain this to taxpayers about why their investment to rescue the banks should not necessarily be in the front of the line, if you will, before the bond holders.

Secretary GEITHNER. That is right, but, you know, our basic obligation again is to help protect the overall economy, the overall financial system, at least cost to the taxpayer. And I am very confident that that commitment I just described that the President said in public and we have all said publicly is the most effective, least cost way to the taxpayer for us to get out of this.

Senator MERKLEY. To restore—to sustain and improve liquidity.

Secretary GEITHNER. Exactly. The President said it best. Economies recover, a well-functioning financial system, credit is the lifeblood of any economy.

Senator MERKLEY. Absolutely.

Secretary GEITHNER. There is no path to recovery that does not start with a better foundation for the provision of credit.

Senator MERKLEY. One of the things that is very frustrating to me is I think many of the circumstances we are in right now could be avoided had we had reasonable rules of the road at both the retail mortgage market and in terms of Wall Street supervision. And at the retail level, something that was troubling is that folks going to their real estate brokers had a lot of protection against conflicts of interest. But when they went to their mortgage broker, their mortgage broker was often paid significant sums if they could steer their client, if you will, and our homeowner into a more expensive loan.

Is it time to end and outlaw steering payments?

Secretary GEITHNER. You are absolutely right that this crisis in part was caused by basic failures of consumer protection. And for some of the reasons we just discussed, we allowed people in this

country to evade basic protections. And it is very important that we put in place a stronger set of basic rules of the road applied more evenly and enforced more carefully so that this thing does not happen again. I completely agree with you. Of course, you want to do that in a way that is sort of careful and is going to be effective, but the basic principle is right.

Senator MERKLEY. When you say you completely agree with me, does that include the detail that we should end steering payments? I like the word "completely," by the way.

Secretary GEITHNER. I meant to say I completely agree with the broad objective. I will look at that carefully. I do believe that the—I have to go back and look, but the Federal Reserve, in cooperation with the other supervisors, put out some very important provisions in terms of new regulations in the fourth quarter of last year that go some distance to addressing that problem. If they do not go far enough, we will take a careful look at how to fix that.

Senator MERKLEY. Thank you. I would love to work with your team in terms of that rule of the road—I see I am over time now—and some other pieces of that consumer rule of the road. Thank you very much for your testimony.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. Secretary Geithner, it is good to have you here, and I know you have been logging some serious hours, and I think that was what Senator Graham was talking about, and he has got my sentiments exactly.

Let me get into something that I think is positive news first. Yesterday I got into the question of the Make Work Pay credit, helping low-income people pay for the higher costs of fuel that result under a cap-and-trade approach. And I was not completely satisfied by the answers, but after the meeting, I got some encouraging news, and I want to kind of review it with you. This involves essentially what is going to happen to the very poor who, in effect, do not file a tax form, and what kind of relief would be available to them.

Now, my understanding, based on some discussions last night, is that the administration would be open to modifying the President's Make Work Pay tax credit and would be willing to consider adding a low-income component that could provide some additional help through States human services agencies to address these kinds of concerns. I found those kinds of reports encouraging last night, and I want to give you a chance to convey some good news.

Are you open to that kind of idea?

Secretary GEITHNER. I am certainly open. I was not part of those conversations, but I will catch up to where you are and confirm your understanding.

Senator WYDEN. That would be very helpful. I would especially appreciate your listening to the good folks at the Center for Budget and Policy Priorities. They have got some very sensible ideas that I think are consistent with the administration's approach in terms of the Make Work Pay credit. It is your desire to compensate people for the higher fuel costs. I am with you on that. But I think Bob Greenstein and the people at the Center for Budget and Policy Priorities have some very good ideas to complement what you are doing, will resolve the matter that became controversial yesterday, and that will be very constructive.

Let me ask you now a couple of questions with respect to AIG. In your view, does the Government have adequate legal authority to prevent future AIGs?

Secretary GEITHNER. No.

Senator WYDEN. Given that, what steps are needed so that the Government does not face yet another all-time record bailout? In an area that to me is especially incomprehensible, when I think about the insurance function, I think about people selling insurance in my home State. It is all about managing risk. And they are stable operations, they are not investment houses, and nothing resembling what happened with AIG. So you have said the Government does not have adequate legal authority to prevent future AIGs. In your view, what is needed specifically to prevent a future debacle like this?

Secretary GEITHNER. Many things. You have to start by making sure that institutions that pose potential risk to the stability of the system in the context of a shock like this have a strong oversight over them with sufficiently conservative constraints on risk taking so that they can withstand very severe stress. AIG was allowed to buildup without any effective supervision, to choose their supervisor, to attach a very risky business to a set of underlying very profitable healthy insurance companies, and that put us in the position where we should never have been as a country.

So you have to have a much stronger form of regulation over those institutions going forward, and you need to make sure that in the event, despite that they get themselves in the position where they are vulnerable, that we have the capacity to deal with those situations in a way that has a more effective balance for the taxpayers as a whole.

So as Chairman Bernanke said 2 days ago or 3 days ago—and I have said publicly this many times in the past—we need a more effective resolution regime as well to deal with situations like this that could cause potential risk to the stability of the system. Those two things are necessary. The challenge is in getting it right, and we are going to work very closely with the Congress on making sure there are adequate tools in place, both to prevent it and to manage it more effectively if it happens.

Senator WYDEN. Will you propose a legislative and regulatory remedy to prevent future AIGs?

Secretary GEITHNER. Yes.

Senator WYDEN. If so, when?

Secretary GEITHNER. We have begun a process of consultation with the relevant committees. I am testifying in the House on the 26th of March. Before that, we plan to lay out a set of relatively detailed concrete proposals to address just this issue.

Senator WYDEN. One question that is immediate, and I started getting into this with Chairman Bernanke. For the live of me, I cannot understand why the American people should not know who the counterparties are that have gotten these billions and billions of dollars through AIG. It has been pointed out in several places that it sure looks like some of this money is going outside the United States. Taxpayers are seeing billions sucked out this way, and for the life of me, I cannot understand why the American people do not have a right to know who the counterparties are.

Secretary GEITHNER. I know—I understand that view and I know that my colleague Chairman Bernanke and his colleagues are looking at how to be responsive to that concern. I know they are on it; they are looking at it. There is a delicate set of legal provisions around confidentiality which we have to figure out how to manage through. But I understand your concern. He is working on it.

Senator WYDEN. All right. I am going to be following up with you on that, because to keep the public in the dark on these counterparties does not pass the smell test, Mr. Secretary. And I am going to followup with you and, again, I appreciate the enormous time commitment that you have given, and we need it now. Thank you.

Thank you, Mr. Chairman.

Secretary GEITHNER. Senator, could I—Mr. Chairman, could I just say one last thing on this point?

Chairman CONRAD. Yes.

Secretary GEITHNER. It is very important to clarify this. You know, when the Government has to act to preserve the stability of the system, we are not doing it for and did not in this context do it for those individual counterparties or because of concern about the direct effects on those counterparties if you were to see a disorderly unwinding of a firm that complicated and systemic. We are doing it because of the much harder to measure indirect effects on confidence and the confidence of all Americans and investors around the world in the basic stability of institutions in the types of insurance savings protections they bought. And it is those effects that are much more important in making the judgment about the stability of the system, but I understand your concern, and I know that my colleagues are working on how to make sure there is a level of transparency responsive to the public concern.

Senator WYDEN. The Chairman has just given me 2 seconds on that point. I think that is a legitimate argument, but to keep people completely in the dark as to who is being rescued and why, in my view, Mr. Secretary, is going to undermine the credibility that you are going to need in order to make additional reforms in the financial sector. So we are going to keep working with you on it.

Thank you, Mr. Chairman.

Secretary GEITHNER. I feel as strongly as you do.

Chairman CONRAD. Let me just say that the commitment we made to the Secretary's people was we would get him out of here at 12:15, and we are close to that. I have one question that I would like to ask.

You have talked about the out-years of the budget achieving deficits 3 percent of GDP. It is about that range that it is necessary to stabilize the debt. What would your recommendation be to us if the Congressional Budget Office comes back and says to us the deficits are not 3 percent of GDP in the out-years, but more like 4 percent of GDP?

Secretary GEITHNER. Of course, that would concern all of us, but you have to look at the sources of the difference in estimates before you figured out how we try to narrow that gap. It depends a little bit on the sources of the differences, and we would have to work through whether those differences are bridgeable. But I think that, you know, what matters is the policies we commit to, together with

the Congress, credible achieve sustainability, and sustainability has to be defined in that envelope around 3.

Chairman CONRAD. I would just say to you that my expectation is CBO is going to come back, and we will know in the days ahead what their prediction is. But my own view is it will probably be in that 4 percent of GDP range as they do their own rescoring of all of this. And so I think we have to be prepared for that.

Senator Gregg had a final question as well.

Senator GREGG. I have a series of quick questions.

When you set up this effort, which is the public-private partnership to get toxic assets off the bank books, I presume what you are saying is that the Government will come in and essentially guarantee that the private sector will not lose money on these assets and that the Government will also benefit in some way. And my question is twofold:

How big a number do you expect to take off the books? And how do you plan to value those assets when you take them off the books and guarantee them?

Secretary GEITHNER. We have said that we think that to be effective in this context, we need to commit to do something in the range of financing available on the order of up to a trillion. We have to examine that over time. You will see us explain the details of that——

Senator GREGG. Will that be done by guarantees?

Secretary GEITHNER. No, that would be the amount of financing——

Senator GREGG. Or insurance?

Secretary GEITHNER. That is the amount of financing that we have to mobilize in this context. Now, on the valuation thing, this is very important. The virtue of this mechanism is that we are going to use a market-based mechanism to determine value of the assets, and that is important because we do not want to put the Government in the position where we are setting an artificially high price that will leave us with more risk than we think the taxpayer will bear. And so the virtue in this—again, just to step back, if you only act after institutions fail, if you only act after your are in a much deeper crisis, you do not have to worry about the valuation problem because, as you saw in the S&L crisis, at that point it is not a complicated question because at that point the Government just has to resolve the institution.

What we are trying to do is much harder, is to act much more preemptively, way before we get to that point, for institutions that we believe are going to be viable, open, and a necessary part of our system going forward. But to do that effectively, we have to solve this valuation problem, and we think this market-based mechanism is going to be the best way to solve that problem at least cost to the taxpayer.

Senator GREGG. Well, that is good. You have given us a number that you are working with, a trillion dollars. What is the risk to the taxpayer in that trillion dollars? Are we going to guarantee the trillion dollars that comes in?

Secretary GEITHNER. No, no. That is——

Senator GREGG. Are we going to insure it or are we going to put a floor underneath?

Secretary GEITHNER. You know, it depends on the precise structure and the amount of capital that we put in alongside the private capital. But the basic principle is we want to limit the downside exposure of the Government, and we want to make sure that we are sharing in any potential return on these assets. And that is a sort of simple, basic proposition because we are doing something that is beneficial for the system in these institutions. We want the Government to be able to share in the potential return on that, you know, as we do when we provide assistance to institutions generally.

Senator GREGG. Maybe I do not understand, but I presume the way you are going to get the private sector to participate is you are basically going to make it profitable to them, or at least potentially profitable to them, by removing their downside risk with taxpayer insurance.

Secretary GEITHNER. They are going to have to take some risk, too. The precise mix of risk and return depends on the precise structure that we design and we lay out, and we are going to begin—as I say, we are going to begin that process relatively quickly by laying out publicly what we think is an appropriate structure for mobilizing as much private capital as we can with an appropriate sharing of the risk and reward. But you are right, it is going to be a complicated balance to strike. But they will have to take risk, too, for it to work, and they are prepared to take some——

Senator GREGG. Well, when you announce this, do you expect that the public, the market, will immediately see that there will be participation of a trillion dollars' worth of effort to try to clear up the toxic balance sheets?

Secretary GEITHNER. I would say you will be able to see immediately the basics of the structure, and you will see a commitment to a level of financing which we think is very substantial. And our expectation is you are going to see—again, because we are providing something the market cannot provide now, which is access to financing, we are going to see private capital come in.

Senator GREGG. Up to a trillion dollar——

Secretary GEITHNER. No, the amount of capital from the private sector will not be in the range of the trillion. The trillion is the amount of financing that we are going to make available generally. The amount of private capital depends a little bit on how we design the precise——

Senator GREGG. Will this be done by the Fed, or will it be done by the Treasury?

Secretary GEITHNER. This will require, given the basic authorities we have together, that we are working together with the Fed and the FDIC, and you will see us lay out the precise mix.

Senator GREGG. And will this require any TARP III money? Or will you be able to do this within the resources you have?

Secretary GEITHNER. We certainly can start it within the resources we have.

Senator GREGG. Thank you.

Chairman CONRAD. Mr. Secretary, you know, you can see what this is like. You know? It is pretty intense at times, but I think very productive. And this represents the best of our democracy, having a serious debate about serious things. And you have done

a superb job. Markets are up over a hundred. I do not know if we can actually attribute that to——

Secretary GEITHNER. That is because of our shared commitment to fiscal responsibility over the medium term.

Chairman CONRAD. Yes, sir. And you know how I believe in this very, very deeply, as I know you do, and we have got an extraordinary responsibility, all of us collectively. And at some point in the future, we will be judged. We will be judged whether we were responsible or not. And I know you want to be judged favorably, so do I, and I think every member of this Committee. We had very, very productive meetings yesterday at the White House with the President, the Vice President, and I think this was a very constructive meeting this morning.

We are getting you out of here a little bit late. I apologize for that. We told your people we could get you out by 12:15, but it is 12:20.

Thank you again for your excellent work, and we very much look forward to the unveiling of the additional plans and hope to have you back to help us better understand them.

Secretary GEITHNER. I look forward to that, and thank you for what you both said. And, Senator Gregg, we share more in common than you believe on——

Senator GREGG. Is that because you went to school at Dartmouth?

[Laughter.]

Secretary GEITHNER. You know, we are going to disagree on some things, but on this basic imperative of getting us back to the path of a sustainable fiscal position, we are absolutely committed to that. Absolutely committed. We may disagree on how best to get there, but we share that commitment. And I completely welcome your personal commitment to that basic objective as well as the Chairman's.

Senator GREGG. There is fertile ground here in this Senate, especially between myself and the Chairman, for accomplishing that goal.

Chairman CONRAD. I thank the Secretary very much.

The Committee will stand in adjournment.

[Whereupon, at 12:22 p.m., the Committee was adjourned.]

THE LONG-TERM BUDGET OUTLOOK

THURSDAY, JULY 16, 2009

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

The Committee met, pursuant to notice, at 9 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Kent Conrad, Chairman of the Committee, presiding.

Present: Senators Conrad, Murray, Feingold, Nelson, Cardin, Whitehouse, Warner, and Gregg.

Staff present: Mary Ann Naylor, Majority Staff Director; and Cheri Reidy, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN CONRAD

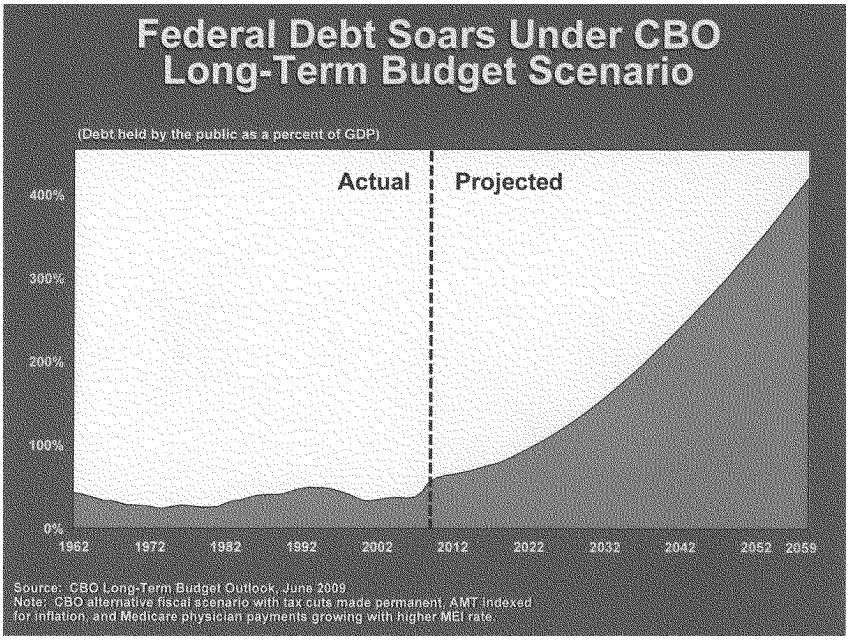
Chairman CONRAD. The hearing will come to order.

I want to welcome CBO Director Elmendorf back to the Budget Committee. I also want to thank him and his very capable staff at CBO for shouldering one of the most crushing workloads that has ever been put on CBO as we consider so many different consequential measures that have enormous fiscal effects, including health care, climate change, and the normal appropriations process.

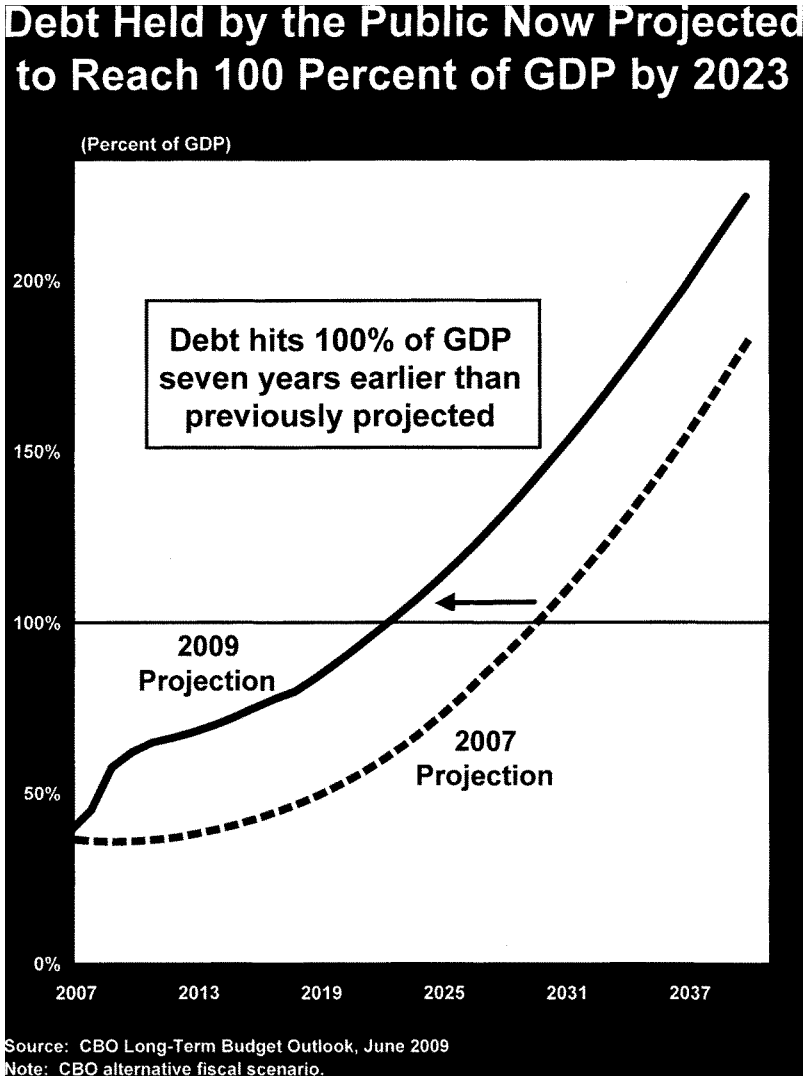
Dr. Elmendorf and his team should be commended for the extraordinary public service they are rendering. Whether we agree with every one of their scoring issues or not is not the point. There is always room for disagreement on scoring matters. What is critical is that we have an objective scorekeeper here that is respected, and Dr. Elmendorf—and the team at CBO—is that independent scorekeeper, and they certainly have my respect.

This hearing will focus on CBO's long-term budget outlook, which was released last month. We have deferred this hearing so that the committees of jurisdiction working on health care would have the full attention of CBO, but we did not believe that this hearing could be further delayed given the importance of the message and the information that is contained in it.

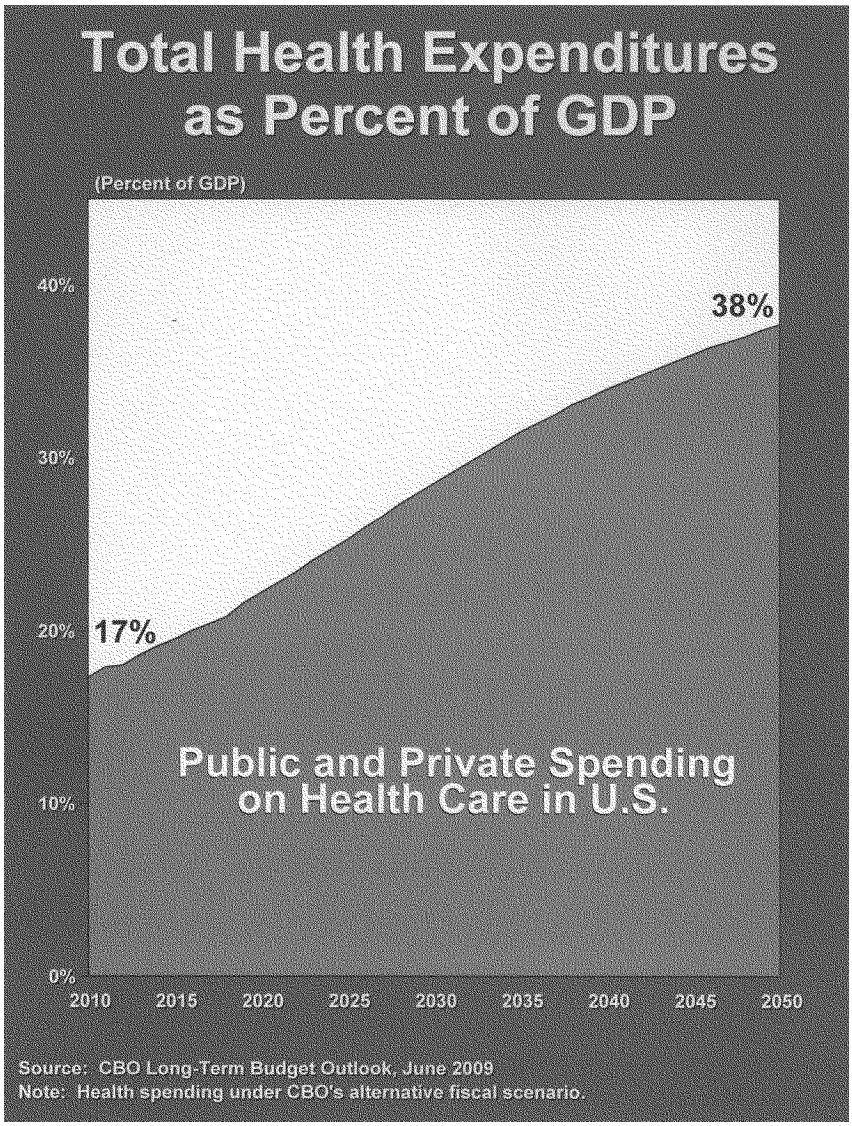
This first chart, updated with data from CBO's new report, shows the outlook for Federal debt under CBO's alternative fiscal scenario. It shows that we are on a completely unsustainable course. Over the next 50 years, with rising health care costs, the retirement of the baby-boom generation, and the permanent extension of the 2001 and 2003 tax cuts, Federal debt will climb to more than 400 percent of the gross domestic product of the United States.



While the long-term debt trajectory is generally unchanged from CBO's report in 2007, we can see that the debt explosion has been moved up in the intermediate term. This is primarily due to the financial crisis and recession and the Federal response to them. Debt held by the public is now projected to reach 100 percent of gross domestic product by 2023, 7 years earlier than previously projected.



Rising health care costs remain the biggest threat to the Federal budget. These rising health costs are exploding the cost of Federal health programs, and private sector health spending is also exploding. According to CBO's report, taken together, public and private health care spending will reach 38 percent of GDP by 2050. That is more than one in every three dollars in this economy just going for health care, and that is a completely unsustainable trajectory.



We can reform our health care system without harming the quality of care. The Dartmouth study found that as much as 30 percent of health spending may not contribute to better health care outcomes. Here is what they found.

30 Percent of Health Spending May Not Contribute to Better Health Outcomes

"Although many Americans believe more medical care is better care, evidence indicates otherwise. Evidence suggests that states with higher Medicare spending levels actually provide lower quality care....

"We may be wasting perhaps 30% of U.S. health care spending on medical care that does not appear to improve our health."

– Dr. Elliott Fisher, Dartmouth Medical School
"More Care is Not Better Care,"
NIHCM Foundation's *Expert Voices*
January 2005

Americans believe that more medical care is better care, but the evidence indicates otherwise. Evidence suggests that States with higher Medicare spending levels actually provide lower-quality care. We may be wasting perhaps 30 percent of health care spending on medical care that does not appear to improve our health.

Senator Gregg and I asked the Congressional Budget Office to provide its best analysis of reform options that get at this long-term cost issue. Here are the key findings.

Key Findings in CBO Letter to Conrad-Gregg on Health Reform and Long-Term Budget

- Without fundamental changes in organization and delivery of care, expanding coverage will worsen long-term outlook
- Paying for reform over 10 years does not guarantee long-term savings
- Focus should be on savings within health system that will grow over time
- Government has two powerful levers for controlling costs: changing Medicare payment rules and limiting tax exclusion for employer-sponsored insurance
- Identifying savings "game changers" will take time and experimentation

– CBO Letter to Senate Budget Committee Chairman Kent Conrad (D-ND) and Ranking Member Judd Gregg (R-NH)
June 16, 2009

One, without fundamental changes in the organization and delivery of care, expanding health insurance coverage will worsen the Nation's long-term budget outlook.

Two, paying for reform over 10 years does not guarantee long-term savings. CBO noted the planned expansion of coverage would be phased in over 10 years, so the full cost would not be apparent until later.

Three, the focus should be on savings within the health care system that will grow over time. CBO emphasized that any offsetting savings enacted outside the health system will likely fail to keep up with the rising costs of health care.

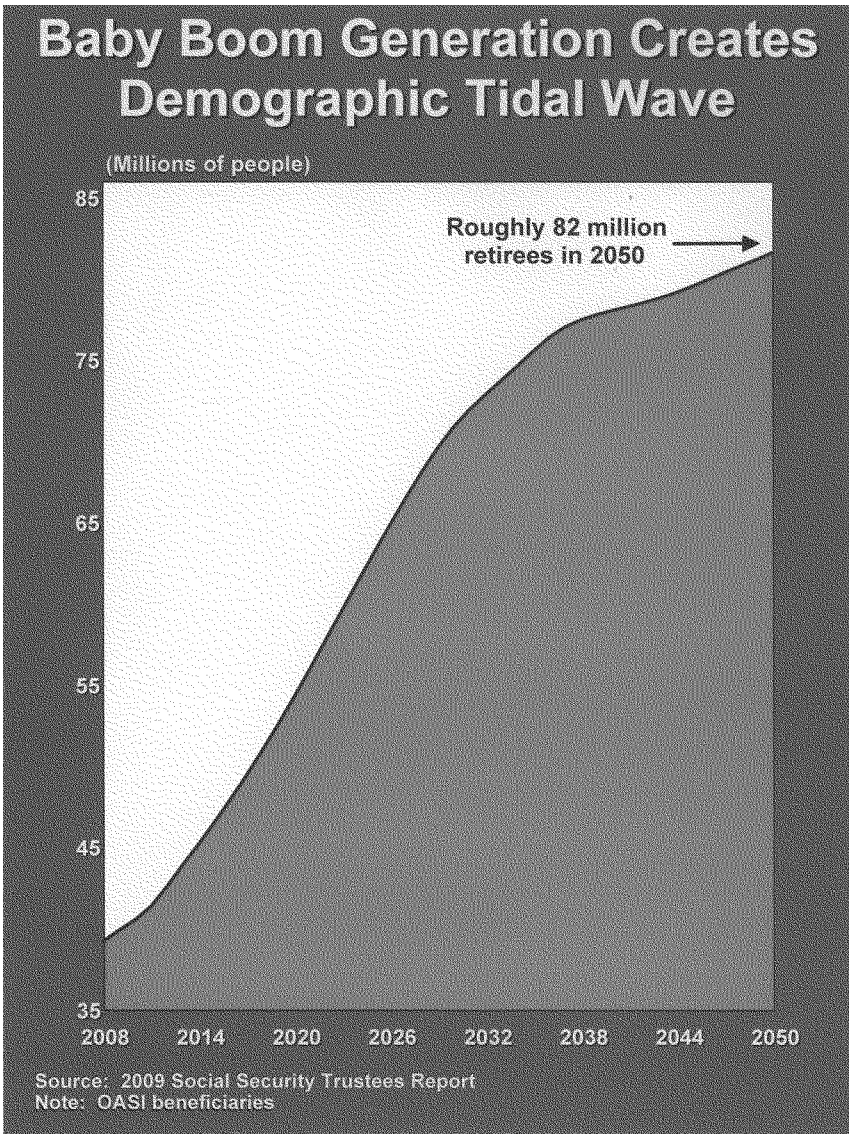
Four, the Government has two powerful levers for controlling costs: changing Medicare payment rules and limiting the tax exclusion for employer-sponsored health insurance.

And, finally, fifth, identifying savings game changers will take time and experimentation.

I hope my colleagues are paying attention to these important findings as we move forward with health care reform.

In addition to health care costs, we also face a demographic challenge that is undeniable. According to this year's Social Security Trustees report, the number of beneficiaries is projected to rise from roughly 40 million people this year to roughly 82 million in 2050. That is a doubling over the next 40 years. And we also face a revenue challenge. The fact is our revenue system is outdated and inefficient. We are suffering from tremendous leakage from the tax gap, offshore tax havens, and abusive of tax shelters. I believe we are now collecting less than 80 percent of what is owed. We need comprehensive tax reform to bring clarity, efficiency, and fairness to the Tax Code and to improve our competitive position in

the world. We have a tax system that was designed at a time when we did not have to worry about our competitive position. We now do.



The former head of the GAO, former Comptroller General Walker, said about the need for more revenue, "You are going to need additional revenue; 18 percent of GDP won't get the job done, even if you end up making entitlement restructuring and spending constraint effective. The gap is just too great."

Former GAO Comptroller General Walker on Solving Nation's Fiscal Problems

"...[Y]ou're going to need additional revenues – 18.2 percent of GDP won't get the job done, even if you end up making entitlement restructuring and spending constraint. The gap is just too great. It's going to have to be more than 18.2 [percent]."

– Former Government Accountability Office Comptroller General David Walker
Testimony before Senate Budget Committee
January 11, 2007

Putting the Nation back on a sound fiscal footing is not going to be easy. If it were easy, it would have already been done. But we have to act, and the CBO report summed it up well. It stated, and I quote, "The difficulty of the choices notwithstanding, CBO's long-term budget projections make clear that doing nothing is not an option. Legislation must ultimately be adopted that raises revenue or reduces spending, or some of both. Moreover, delaying action simply exacerbates the challenge."

CBO on Addressing Long-Term Budget Outlook

"The difficulty of the choices not withstanding, CBO's long-term budget projections make clear that doing nothing is not an option: Legislation must ultimately be adopted that raises revenue or reduces spending or both. Moreover, delaying action simply exacerbates the challenge..."

–CBO's Long-Term Budget Outlook
June 2009

I am going to end on that point and simply say that Senator Gregg and I have made a proposal about how to tackle these long-term issues. I am also announcing today that we are calling back the Deficit Reduction Caucus to action. We had a first meeting yesterday. I am inviting members of both parties to join the Deficit Reduction Caucus. We are going to reinvigorate that effort, which was effective over a very long period of time in getting us back to balance in the 1990's. I think it is timely that we restore a focus to deficit and debt reduction, and that will be the work of that caucus.

So I invite members on both sides to join. Our intention will be to meet monthly and to develop a plan to address these long-term issues. The time for doing nothing has passed.

With that, I turn to the very able Ranking Member, Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Thank you, Mr. Chairman. Let me join with you and, I think, all Members of the Senate in thanking the Director and the staff of CBO for the extraordinarily effective and professional way you have handled the immense workload that has been put on you as a result of the health care—primarily, the health care bills being brought forward. And we certainly thank you on our side of the aisle for being fair and objective and being an honest umpire of the numbers, and that has been very important as we have proceeded here.

I want to echo much of what the Chairman said. I think the key to what the Chairman said is that this issue of the deficit and the debt is spiraling our Nation downward to a point where we may not have fiscal sustainability. We are looking at basically a debt

which will exceed anything in our history other than during the period of World War II and a debt which has no end in sight. And as a result, we are basically headed on a path of financial bankruptcy for our children, and it is not right. And it is mostly being driven—although there is definitely a revenue component to this, it is mostly being driven on the spending side of the ledger. Spending is growing from about 20 percent of the gross national product up to 24 or 25 or 26 percent of the gross national product.

A large amount of that is driven, of course, by the health care and the demographic situation which we confront as a Nation, which is going to cause greater utilization of health care. And I think the key here is that as we look at all these health care bills, we have to put in place systems within these bills if we are going to pass health care reform which are going to lead to a long-term reduction in the rate of growth of health care spending in this country. And so far we have not seen that. At least we have not seen it, in my opinion, in the House bill, and we definitely did not see it in the bill reported out of the Committee which I serve on—Health, Education, Labor, and Pensions. In fact, just the opposite. That bill increases spending by $2.2 trillion over the first 10 years if you were to fully phase it in. And it increases spending in the second 10 years by more than $2 trillion. That is spending. Some of that is offset but not much.

And as a very practical matter, you cannot grow the Government at that rate and catch your tail. You cannot keep up with the debt that will have to be added because the cost is just too high. And so we have got to come at this from a different direction, in my opinion.

Now, you have outlined to us the two themes which we should be pursuing if we are going to effectively bend the out-year cost curve in a letter to myself and Senator Conrad, and those two themes were:

One, that we need to change our tax policy relative to deductibility of health insurance, which makes obvious sense. If you are incentivizing people to overutilize the system through the tax laws, you are driving up health care costs. And if you are looking for revenues to basically address the issue of the uninsured, you should look within the health community. And why should you be funding gold-plated health insurance policies? And so I greatly regret that there is a movement to take off the table one of the two items that you in your letter pointed out to us was most important for the purposes of controlling your health care costs, which is to basically make the deductibility of health insurance—high-end policies, especially—bring those into the debate. And we should not take that off the table because I think your counsel there is excellent.

The second, of course, was that the reimbursement system has to change, and there are a lot of different proposals out there to do that, but I tend to think the best way to accomplish that is by incentivizing both the user to pursue healthy lifestyles and the provider to deliver quality at lower costs. And the way you incentivize people is with cash and creating systems which accomplish that.

So I thank you for your counsel in this area, but I do not sense that your counsel is being taken. At least neither the House bill nor the bill reported by the HELP Committee addressed effec-

tively—in fact, did not address at all, the first point—it took that off the table—address effectively the two points which you have made for addressing—for bending the out-year cost curve of health care.

And so I will be interested to hear what your thoughts are in that area, and we certainly appreciate your continued presentation to us of the information which is critical for us to make public policy decisions.

Thank you.

Chairman CONRAD. Thank you, Senator Gregg. And, again, Dr. Elmendorf, welcome back to the Budget Committee, and please proceed with your testimony.

STATEMENT OF DOUGLAS W. ELMENDORF, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ELMENDORF. Thank you, Mr. Chairman, Senator Gregg, and members of the Committee. It is good to be back. I also want to thank you on behalf of my terrific colleagues for your appreciation and support for the work that we are doing. And I appreciate the opportunity to testify today about CBO's most recent analysis of the long-term budget outlook.

Under current law, the Federal budget is on an unsustainable path. Federal debt will continue to grow much faster than the economy over the long run. Although great uncertainty surrounds long-term fiscal projections, rising costs for health care and the aging of the population will cause Federal spending to increase rapidly under any plausible scenario for current law. Unless revenues increase just as rapidly, the rise in spending will produce growing budget deficits and accumulating debt that would cause substantial harm to the economy.

This slide shows our projection of Federal debt relative to GDP under the two scenarios we model. Keeping deficits and debt from reaching these levels will require increasing revenues significantly as a share of GDP, decreasing projected spending sharply, or some combination of the two.

Measured relative to GDP, almost all of the projected growth in Federal spending, other than interest payments on the debt, stems from the three largest entitlement programs; Medicare, Medicaid, and Social Security. For decades, spending on Medicaid and Medicare have outpaced the economy. CBO projects that if current laws do not change, Federal spending on those two programs combined will grow from about 5 percent of GDP today to almost 10 percent by 2035. By 2080, the Government would be spending as much as a share of the economy on just these two major programs as it has spent on all of its programs and services in recent years.

In our estimates, the increase in the spending for Medicare and Medicaid will account for 80 percent of the total spending increases of these three entitlement programs between now and 2035 and 90 percent of spending growth between now and 2080. Thus, reducing overall Government spending relative to what would occur under current law would require fundamental changes in the trajectory of Federal health spending. Slowing the growth rate of outlays for Medicare and Medicaid is the central fiscal challenge.

Under current law, spending on Social Security is also projected to rise over time as a share of GDP, but much less sharply. CBO projects that Social Security spending will increase from less than 5 percent of GDP today to about 6 percent in 2035 and then roughly stabilize at that level.

Meanwhile, as shown in this slide—actually, I don't think I have—sorry. As shown in this slide, Government spending on all activities other than Medicare, Medicaid, Social Security, and interest on the Federal debt is projected to decline or stay roughly stable as a share of GDP in future decades. This is the collection of everything outside of these three large programs and interest that includes national defense and a wide variety of domestic programs. And under our projections that lead to those unsustainable debt paths, this spending actually is at or below the levels that we have experienced throughout the last several decades.

Federal spending on Medicare and Medicaid and Social Security will grow relative to the economy both because health care spending per beneficiary is projected to increase and because the population is aging. As shown in this slide, between now and 2035, aging is projected to make the larger contribution to the growth of spending for those three programs as a share of GDP. After 2035, continued increases in health care spending per beneficiary is projected to dominate the growth in the spending for the three programs.

I should note that the current recession and policy responses have little effect on long-term projections of non-interest spending and of revenues, but they do matter for future interest spending. We estimate that in fiscal years 2009 and 2010 the Federal Government will record its largest budget deficits as a share of GDP since shortly after World War II. As a result of those deficits, Federal debt held by the public will soar from 41 percent of GDP at the end of fiscal year 2008 to more than 60 percent at the end of fiscal year 2010. This higher debt results in permanently higher spending to pay interest on that debt. Federal interest payments already amount to more than 1 percent of GDP. Unless current law changes, that share would rise to 2.5 percent by 2020.

CBO's long-term budget projections raise fundamental questions about economic sustainability. I return to the initial slide. If outlays grew as projected and revenues did not rise at a corresponding rate, annual deficits would climb and Federal debt would grow well beyond our historical experience. Larger budget deficits would reduce national savings, leading to more borrowing from abroad and less domestic investment, which in turn would depress incomes in the United States. Over time, the accumulation of debt would seriously harm the economy.

Alternatively, if spending grew as projected and taxes were raised in tandem, tax rates would have to reach levels never seen in the United States. High tax rates would slow the growth of the economy, making the spending burden harder to bear.

Policymakers could mitigate the economic damage from rapidly rising debt by putting the Nation on a sustainable fiscal course, which would require some combination of lower spending and higher revenues than the amounts now projected. Making such changes

sooner rather than later would lessen the risks that current fiscal policy poses to the economy.

Thank you. I am happy to take any questions.

[The prepared statement of Mr. Elmendorf follows:]

Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

The Long-Term Budget Outlook

before the
Committee on the Budget
United States Senate

July 16, 2009

This document is embargoed until it is delivered at 9:00 a.m. (EDT) on Thursday, July 16, 2009. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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

Chairman Conrad, Senator Gregg, and Members of the Committee, thank you for inviting me to testify on the Congressional Budget Office's (CBO's) most recent analysis of the long-term budget outlook. My statement describes the pressures facing the federal budget over the coming decades by presenting the agency's current projections of federal spending and revenues through 2080.[1]

Under current law, the federal budget is on an unsustainable path—meaning that federal debt will continue to grow much faster than the economy over the long run. Although great uncertainty surrounds long-term fiscal projections, rising costs for health care and the aging of the U.S. population will cause federal spending to increase rapidly under any plausible scenario for current law. Unless revenues increase just as rapidly, the rise in spending will produce growing budget deficits and accumulating debt. Keeping deficits and debt from reaching levels that would cause substantial harm to the economy would require increasing revenues significantly as a percentage of gross domestic product (GDP), decreasing projected spending sharply, or some combination of the two.

Measured relative to GDP, almost all of the projected growth in federal spending other than interest payments on the debt comes from growth in spending on the three largest entitlement programs—Medicare, Medicaid, and Social Security. For decades, spending on the federal government's major health care programs, Medicare and Medicaid, has been growing faster than the economy (as has health care spending in the private sector). CBO projects that if current laws do not change, federal spending on Medicare and Medicaid combined will grow from roughly 5 percent of GDP today to almost 10 percent by 2035 and to more than 17 percent by 2080. That projection means that in 2080, without changes in policy, the federal government would be spending almost as much, as a share of the economy, on just its two major health care programs as it has spent on all of its programs and services in recent years.

By CBO's estimates, the increase in spending for Medicare and Medicaid as a share of GDP will account for 80 percent of spending increases for the three entitlement programs between now and 2035 and 90 percent of spending growth between now and 2080. Thus, reducing overall government spending relative to what would occur under current fiscal policy would require fundamental changes in the trajectory of federal health spending. Slowing the growth rate of outlays for Medicare and Medicaid is the central long-term challenge for federal fiscal policy.

Under current law, spending on Social Security is also projected to rise over time as a share of GDP, albeit much less dramatically. CBO projects that Social Security spending will increase from less than 5 percent of GDP today to about 6 percent in 2035 and then roughly stabilize at that level through 2080. Under the assumptions used for CBO's long-term projections, government spending on activities other than Medicare, Medicaid, Social Security, and interest on federal debt—activities such as national defense and a wide variety of domestic programs—is projected to decline or stay roughly stable as a share of GDP in future decades.

Federal spending on Medicare, Medicaid, and Social Security will grow relative to the economy both because health care spending per beneficiary is projected to increase and because the population is aging. Spending on Medicare and Medicaid will be driven by both factors, while Social Security spending will rise because of the population's aging. Between now and 2035, aging is projected to make the larger contribution to the growth of spending for those three programs as a share of GDP. After 2035, continued increases in health care spending per beneficiary are projected to dominate the growth in spending for the three programs.

The current recession has little effect on long-term projections of noninterest spending and revenues. But CBO estimates that in fiscal years 2009 and 2010, the federal government will record its largest budget deficits as a share of GDP since shortly after World War II. As a result of those deficits, federal debt held by the public will soar from 41 percent of GDP at the end of fiscal year 2008 to 60 percent at the end of fiscal year 2010. Higher debt results in permanently higher spending to pay interest on that debt (unless the debt is later paid off). Federal interest payments already amount to more than 1 percent of GDP; unless current law changes, that share would rise to 2.5 percent by 2020.

1. Those projections appear in Congressional Budget Office, *The Long-Term Budget Outlook* (June 2009).

CBO's long-term budget projections raise fundamental questions about economic sustainability. If outlays grew as projected and revenues did not rise at a corresponding rate, annual deficits would climb and federal debt would grow significantly. Large budget deficits would reduce national saving, leading to more borrowing from abroad and less domestic investment, which in turn would depress income growth in the United States. Over time, the accumulation of debt would seriously harm the economy. Alternatively, if spending grew as projected and taxes were raised in tandem, tax rates would have to reach levels never seen in the United States. High tax rates would slow the growth of the economy, making the spending burden harder to bear. Policymakers could mitigate the economic damage from rapidly rising debt by putting the nation on a sustainable fiscal course, which would require some combination of lower spending and higher revenues than the amounts now projected. Making such changes sooner rather than later would lessen the risks that current fiscal policy poses to the economy.

Alternative Scenarios for the Long-Term Budget Outlook

Long-term projections rely on numerous assumptions about economic and fiscal factors, and many different assumptions are possible. In this report, CBO presents two scenarios that are based on alternative assumptions about the federal budget over the long term (see Table 1):

- The "extended-baseline scenario" adheres most closely to current law, following CBO's 10-year baseline budget projections for the next decade and then extending the baseline concept beyond that 10-year window.[2] The scenario's assumption of current law implies that many policy adjustments that lawmakers have routinely made in the past will not occur.
- The "alternative fiscal scenario" represents one interpretation of what it would mean to continue today's underlying fiscal policy. This scenario deviates from CBO's baseline even during the next 10 years because it incorporates some policy changes that are widely expected to occur and that policymakers have regularly made in the past. Different analysts might perceive the underlying intention of current policy differently, however, and other interpretations are possible.

CBO projects that under both scenarios, primary spending—all spending except interest payments on federal debt—would grow sharply in coming decades relative to its historical relationship to GDP. Those projections are consistent with CBO's 2007 long-term budget outlook. Stimulus legislation and efforts to stabilize the financial markets will push primary spending up to 26 percent of GDP this fiscal year, the highest level since World War II; primary spending is projected to decline to 20 percent of GDP by fiscal year 2012.

Under the extended-baseline scenario, primary spending would edge down further as a share of GDP for several years, to 19 percent. It would then begin a long-term upward trajectory, reaching 24 percent of GDP in 2035 and 32 percent in 2080 (see Figure 1). Under the alternative fiscal scenario, by comparison, primary spending would be about 2 percentage points higher as a share of GDP than in the extended-baseline scenario throughout the projection period (see Figure 2).

If spending policies did not change and outlays indeed grew to the projected levels relative to the size of the economy, maintaining a sustainable budget path would require a similar rise in federal taxation. The recession has temporarily depressed revenues to an estimated 16 percent of GDP in this fiscal year. But even typical revenue levels would be too low to support projected spending. Over the past half-century, total federal revenues have averaged about 18 percent of GDP—well below the level of projected spending under either scenario.

2. CBO's baseline is a benchmark for measuring the budgetary effects of proposed changes in federal revenues or spending. It comprises projections of budget authority, outlays, revenues, and the deficit or surplus calculated according to rules set forth in the Balanced Budget and Emergency Deficit Control Act of 1985. Those projections are not intended to be predictions of future budgetary outcomes; rather, they represent CBO's best judgment of how economic and other factors would affect federal revenues and spending if current laws and policies did not change.

Table 1.

Assumptions About Federal Spending and Revenue Sources Underlying CBO's Long-Term Budget Scenarios

	Extended-Baseline Scenario	Alternative Fiscal Scenario
	Assumptions About Spending	
Medicare	As scheduled under current law	Physician payment rates grow with the Medicare economic index (rather than at the lower growth rates scheduled under the sustainable growth rate mechanism)
Medicaid	As scheduled under current law	As scheduled under current law
Social Security	As scheduled under current law	As scheduled under current law
Other Spending Excluding Interest[a]	As projected in CBO's 10-year baseline through 2019, remaining thereafter at the projected 2019 level as a share of GDP	As projected in CBO's baseline through 2011, remaining thereafter at the projected 2009 level, minus stimulus and related spending, as a share of GDP
	Assumptions About Revenue Sources	
Individual Income Taxes	As scheduled under current law	Tax provisions in JGTRRA and EGTRRA are extended and AMT parameters are indexed for inflation after 2009
Corporate Income Taxes	As scheduled under current law	As scheduled under current law
Payroll Taxes	As scheduled under current law	As scheduled under current law
Excise Taxes and Estate and Gift Taxes	As scheduled under current law	Constant as a share of GDP over the long term
Other Revenues	As scheduled under current law through 2019, remaining constant as a share of GDP thereafter	As scheduled under current law through 2019, remaining constant as a share of GDP thereafter

Source: Congressional Budget Office.

Notes: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2009 to 2019 and then extending the baseline concept for the rest of the projection period. The alternative fiscal scenario deviates from CBO's baseline projections, beginning in 2010, by incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

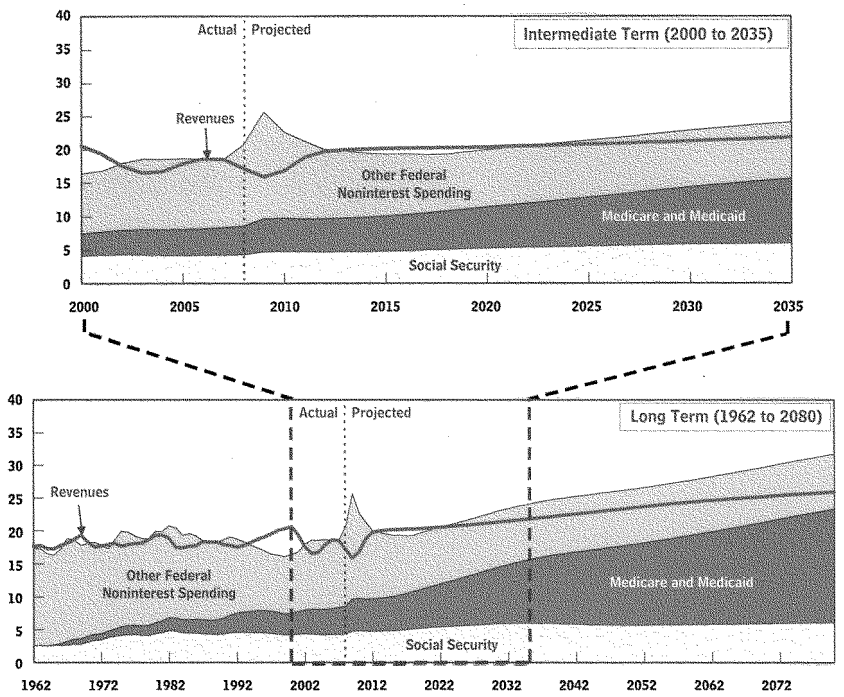
GDP = gross domestic product; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; AMT = alternative minimum tax.

a. Federal spending on the refundable portions of the earned income tax credit and the child tax credit is not held constant as a percentage of GDP but instead is modeled with the revenue portion of the scenarios.

Figure 1.

Federal Revenues and Noninterest Spending, by Category, Under CBO's Extended-Baseline Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office.

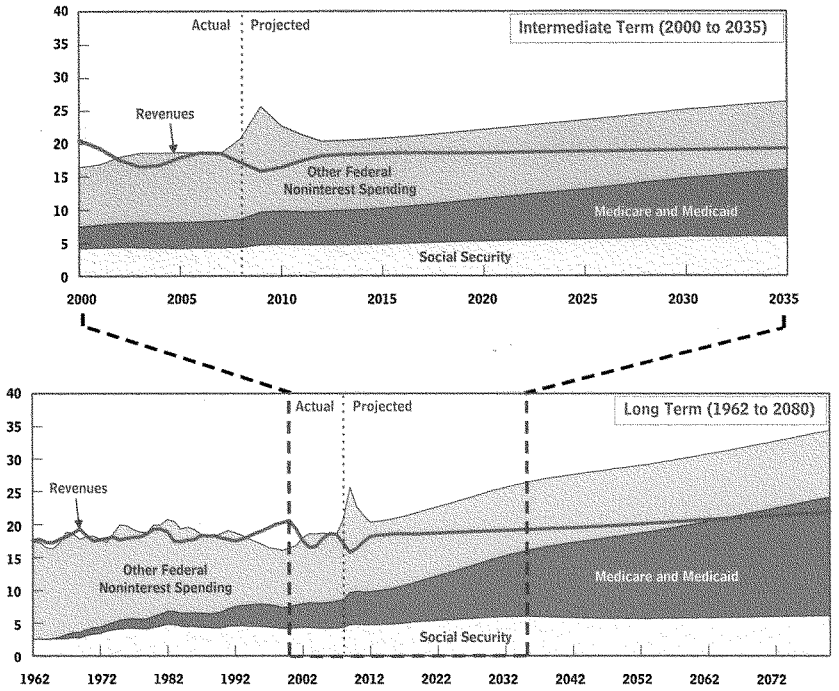
Notes: Spending in this figure excludes interest payments on the debt; hence, the gap between federal revenues and noninterest spending shown here does not equal the projected surplus or deficit.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2009 to 2019 and then extending the baseline concept for the rest of the projection period.

Figure 2.

Federal Revenues and Noninterest Spending, by Category, Under CBO's Alternative Fiscal Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office.

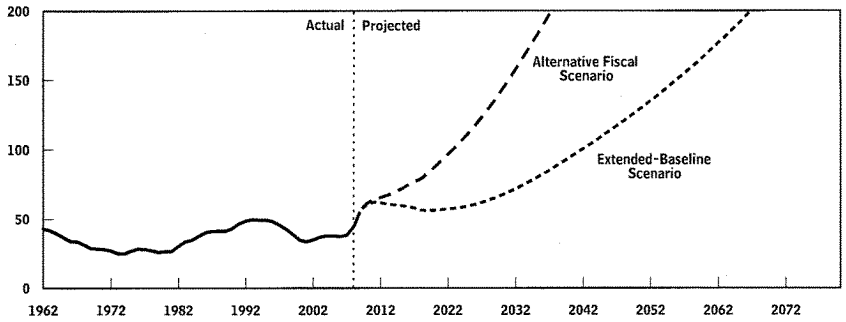
Notes: Spending in this figure excludes interest payments on the debt; hence, the gap between federal revenues and noninterest spending shown here does not equal the projected surplus or deficit.

The alternative fiscal scenario deviates from CBO's baseline projections, beginning in 2010, by incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

Figure 3.

Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2009 to 2019 and then extending the baseline concept for the rest of the projection period. The alternative fiscal scenario deviates from CBO's baseline projections, beginning in 2010, by incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

Under the extended-baseline scenario, revenues would reach higher levels relative to the economy than ever recorded in the nation's history. That scenario assumes that reductions in tax rates enacted in 2001 and 2003 will expire at the end of 2010 as scheduled under current law. It also assumes that the alternative minimum tax (AMT) will not be changed, and because its parameters are not indexed to inflation like most of the tax code, its reach would expand substantially over time.[3] In addition, ongoing increases in real (inflation-adjusted) income would push taxpayers into higher income tax brackets. For all of those reasons, the extended-baseline scenario implies that federal revenues will grow somewhat faster, on average, than the economy—increasing from 20 percent of GDP in fiscal year 2012 to 22 percent by 2035 and 26 percent by 2080. But even if revenues rose to those unprecedented levels, they would not be sufficient to keep the budget in balance over the long term in that scenario. Federal debt held by the public would stay near 60 percent of GDP during the coming decade but then would turn upward and reach 79 percent of GDP by 2035 (see Figure 3 and Table 2). In the absence of policy changes, by 2046 the ratio of debt to GDP would be higher than the level that the United States experienced shortly after World War II.

Under the alternative fiscal scenario, by contrast, expiring tax provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) would be extended, and the AMT would be indexed to inflation. As a result, revenues would grow only slightly faster than the economy, equaling 22 percent of GDP by 2080. Slowly growing revenues combined with sharply rising expenditures would create an explosive fiscal situation. Under the spending and revenue policies incorporated in this scenario, federal debt would surpass 100 percent of GDP in 2023 and exceed 200 percent of GDP by the late 2030s.

3. The AMT is a parallel income tax system with fewer exemptions, deductions, and rates than the regular income tax. Households must calculate the amount of tax they owe under both the AMT and the regular income tax and pay the larger of the two amounts.

Table 2.

Projected Federal Spending and Revenues Under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)

	2009[a]	2020	2035	2050	2080
			Extended-Baseline Scenario		
Primary Spending					
Social Security	4.8	5.3	6.0	5.7	6.1
Medicare[b]	3.5	4.0	6.9	9.0	13.5
Medicaid	1.8	2.1	2.8	3.2	3.7
Other noninterest spending	16.0	8.6	8.5	8.4	8.4
Subtotal, primary spending	26.2	20.0	24.1	26.3	31.7
Interest	1.2	2.6	3.3	5.4	11.9
Total Spending	27.4	22.6	27.4	31.7	43.7
Revenues	15.5	20.3	21.8	23.4	25.9
Deficit (-) or Surplus					
Primary deficit or surplus	**-10.7**	**0.4**	**-2.3**	**-2.9**	**-5.9**
Total deficit	**-11.9**	**-2.3**	**-5.6**	**-8.3**	**-17.8**
Debt Held by the Public	55	56	79	128 [c]	283 [c]
			Alternative Fiscal Scenario		
Primary Spending					
Social Security	4.8	5.3	6.0	5.7	6.2
Medicare[b]	3.5	4.3	7.2	9.5	14.3
Medicaid	1.8	2.1	2.8	3.2	3.7
Other noninterest spending	16.0	10.5	10.4	10.3	10.3
Subtotal, primary spending	26.2	22.1	26.4	28.7	34.4
Interest	1.2	3.9	7.5	13.5	30.3
Total Spending	27.4	26.0	33.9	42.2	64.7
Revenues	15.5	18.6	19.2	19.9	21.9
Deficit (-) or Surplus					
Primary deficit or surplus	**-10.7**	**-3.5**	**-7.2**	**-8.8**	**-12.5**
Total deficit	**-11.9**	**-7.4**	**-14.6**	**-22.2**	**-42.8**
Debt Held by the Public	55	87	181 [c]	321 [c]	716 [c]

Source: Congressional Budget Office.

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections from 2009 to 2019 and then extending the baseline concept for the rest of the projection period. The alternative fiscal scenario deviates from CBO's baseline projections, beginning in 2010, by incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

a. Data for 2009 are on a fiscal year basis; all other data are on a calendar year basis.

b. Spending for Medicare is net of premiums and amounts paid by states from savings on Medicaid prescription drug costs.

c. Such high levels of debt to GDP would have severe effects on the economy that are not illustrated here. For further discussion, see the section "The Economic Impact of Rising Federal Debt" on page 15.

Box 1.

Calculating the Fiscal Gap

One way to gauge the federal government's financial status is to examine projections of annual revenues and spending. Another way is to look at present-value measures that summarize the government's expected long-term flows of revenues and spending in a single number. (A present-value calculation adjusts future payments for the time value of money to make them comparable with payments today.) The fiscal gap is a present-value measure of the nation's fiscal imbalance.

That imbalance reflects federal shortfalls over a given period. It represents the extent to which the government would need to immediately and permanently raise tax revenues, cut spending, or use some mix of both to make the government's debt the same size (relative to the size of the economy) at the end of that period as it was at the beginning.

The Congressional Budget Office (CBO) calculates the present value of a stream of future revenues by taking the revenues for each year, discounting each value to 2009 dollars, and then summing the resulting series. (CBO used a real [inflation-adjusted] discount rate based on the interest rate on debt held by the public, assumed to be 3.0 percent in the long term.) The same method is applied to the projected stream of outlays.[1] CBO also computes a present value for future gross domestic product (GDP) so it can calculate the present value of outlays and revenues as a share of the present value of GDP (see the table at the right).

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

(Percentage of gross domestic product)

Projection Period	Revenues	Outlays	Fiscal Gap
	Extended-Baseline Scenario		
25 Years (2009–2033)	21.6	23.7	2.1
50 Years (2009–2058)	22.0	24.6	2.6
75 Years (2009–2083)	22.7	25.9	3.2
	Alternative Fiscal Scenario		
25 Years (2009–2033)	19.9	25.3	5.4
50 Years (2009–2058)	19.6	26.5	6.9
75 Years (2009–2083)	19.9	28.0	8.1

Source: Congressional Budget Office.

1. To allow for the increase in the nominal value of the debt that would occur even if that debt was maintained at its current share of gross domestic product (GDP), the present value of outlays is adjusted to account for that change in the debt. Specifically, the current debt is added to the outlay measure, and the present value of the target end-of-period debt is subtracted. (The end-of-period debt is equal to GDP in the last year of the period multiplied by the 2008 ratio of debt to GDP.)

Returning the Budget to a Sustainable Path

How much would policies have to change to avoid unsustainable increases in government debt? A useful answer comes from looking at the so-called fiscal gap. The gap measures the immediate change in spending or revenues that would be necessary to produce the same debt-to-GDP ratio at the end of a given period as prevailed at the beginning of the period. Under the extended-baseline scenario, the fiscal gap would amount to 2.1 percent of GDP over the next 25 years and 3.2 percent of GDP over the next 75 years. In other words, under that scenario (ignoring the effects of debt on economic growth), an immediate and permanent reduction in spending or an immediate and permanent increase in revenues equal to 3.2 percent of GDP would be needed to create a sustainable fiscal path for the next three-quarters of a century. If the policy change was not immediate, the required percentage would be greater. The fiscal gap is much larger under the alternative fiscal scenario: 5.4 percent of GDP over the next 25 years and 8.1 percent over the next 75 years. (For information about how CBO makes those estimates, see Box 1.)

Long-term budget projections require a stable economic backdrop. For these projections, CBO assumed that even a large increase in federal debt would not affect economic growth or real rates of interest after the first 10 years.[4] However, if debt actually increased as projected under either scenario, interest rates would be higher than otherwise and economic growth would be slower. The rising debt would reduce the size of the domestic capital stock (businesses' equipment and structures as well as housing) and decrease U.S. ownership of assets in other countries while increasing foreign ownership of assets in the United States. Those changes would slow the growth of gross national product (GNP) and, as the debt burden rose, could eventually lead to a decline in economic output.[5] The effects would be most striking under the alternative fiscal scenario. In CBO's estimation, the increase in debt under that scenario would reduce the capital stock by more than 20 percent and real GNP by 9 percent in 2035, compared with the levels that would occur if the debt remained roughly at its current size relative to the economy. Under the extended-baseline scenario, federal debt would be less threatening in the near term but would lead to significant economic harm in the long run. Those economic effects mean that actual fiscal pressures under current laws and policies would be even greater than CBO's long-term budget projections suggest, because slower growth would limit revenues and a smaller capital stock would imply higher interest rates on government debt and other financial instruments.

Holding down the spiraling levels of debt projected under either scenario could therefore result in significant economic benefits. However, accomplishing that goal would require some combination of substantial revenue increases and substantial spending decreases relative to current law. Those changes would have their own economic and social costs.

One policy that would prevent the increase in debt would be to raise revenues in line with the projected rise in spending. As evidenced by the estimated fiscal gap, the required increase in revenues under that approach would be large. If the increase occurred through higher marginal tax rates, incentives to work and save would be reduced and economic growth would slow.

An alternative policy would be to hold the growth of spending in line with the growth of the economy. That approach would require significant changes in the Medicare and Medicaid programs. Many experts believe that a substantial share of spending on health care contributes little, if anything, to the overall health of the nation, so changes in government policy have the potential to yield large reductions in federal spending without harming health. However, translating that potential into reality would require tough choices. It would ultimately depend on policymakers' willingness to put ongoing pressure on the health sector to achieve efficiencies in the delivery of health care.

4. For a description of the model underlying CBO's projections, see the June 2009 background paper *CBO's Long-Term Model: An Overview.*

5. Gross national product measures the income of residents in the United States after deducting net payments to foreigners. Gross domestic product, by contrast, measures the income that is generated by the production of goods and services on U.S. soil, including production financed by foreign investors. Because rising deficits generally increase borrowing from foreigners, GNP is a better measure of the economic effects of deficits than is GDP.

Table 3.

Shares of the Growth in Spending for the Three Largest Entitlement Programs

	Percentage of Growth
For the 2009–2035 Period	
Medicare and Medicaid	80
Social Security	20
For the 2009–2080 Period	
Medicare and Medicaid	90
Social Security	10

Source: Congressional Budget Office.

Reducing other federal spending significantly below the baseline levels would be difficult as well. Spending on Social Security has risen from almost 4 percent of GDP in the 1970s to almost 5 percent today and will increase to 6 percent in 2035 as the baby boomers retire. Other nonhealth, noninterest spending averaged almost 14 percent of GDP in the 1970s but has shrunk to about 10 percent of GDP over the past 15 years—aside from the current burst of spending in response to the recession and the financial crisis. Such spending is projected to decline further over time in CBO's 10-year baseline.

From a purely economic perspective, slowing the growth of spending would generally impose smaller costs than boosting tax rates, although that conclusion is somewhat sensitive to the specific measures that would be adopted. From a broader social perspective, citizens and policymakers need to judge the importance of various government programs and the costs of restraining spending on health care, retirement benefits, defense, and so on. That is, lower levels of spending would help address the fiscal sustainability problem, but society would have to make difficult choices about which programs to scale back. The difficulty of the choices notwithstanding, CBO's long-term budget projections make clear that doing nothing is not an option: Legislation must ultimately be adopted that raises revenue or reduces spending or both. Moreover, delaying action simply exacerbates the challenge, as is discussed below.

The Outlook for Federal Spending

For much of its history, the United States devoted only a small fraction of its resources to the activities of the federal government, apart from fighting wars. But the second half of the 20th century was a period of sustained higher federal spending during peacetime. Over the past 50 years, primary federal outlays (which exclude interest spending) have averaged 18 percent of GDP. In fiscal years 2009 and 2010, spending on stimulus legislation and on efforts to stabilize the financial markets will result in unusually high outlays (primary spending will account for 26 percent of GDP in fiscal year 2009), but outlays are projected to fall back near their historical average after a few years.

In later years, primary spending rises again in both of CBO's long-term budget scenarios. Under the extended-baseline scenario, primary spending would increase from 20 percent of GDP in fiscal year 2012 to 24 percent by 2035 and 32 percent by 2080. Primary spending would be even higher under the alternative fiscal scenario, reaching 26 percent of GDP by 2035 and 34 percent by 2080. Those higher levels occur largely because the alternative fiscal scenario assumes greater spending on federal programs other than Medicare, Medicaid, and Social Security than the extended-baseline scenario does.

Outlays for Medicare, Medicaid, and Social Security

Over the past 50 years, federal spending has increased as a percentage of GDP, and its composition has changed dramatically. Spending for mandatory programs has grown from about 30 percent of noninterest outlays in the early 1960s to about 60 percent in recent years. Most of that growth has been concentrated in the three largest entitlement programs: Medicare, Medicaid, and Social Security. Together, federal outlays for those three programs have accounted for roughly 45 percent of primary federal spending over the past 10 years, up from 25 percent in 1975.

In the future, projected growth in entitlement spending explains almost all of the projected growth in total noninterest spending—and the two big government health care programs largely drive that increase. Medicare and Medicaid are responsible for 80 percent of the growth in spending on the three largest entitlements over the next 25 years and for 90 percent of that growth by 2080 (see Table 3). CBO projects that net federal spending on

Medicare and Medicaid will rise from about 5 percent of GDP in fiscal year 2009 to about 10 percent in 2035 and over 17 percent in 2080.[6] Spending on Social Security is projected to rise at a much slower pace, from almost 5 percent of GDP in 2009 to about 6 percent in later years.

Two factors account for the projected growth in the government's three largest entitlement programs: the aging of the population and the rapid growth of per capita health care costs. The retirement of the baby-boom generation (the large group of people born between 1946 and 1964) portends a long-lasting shift in the age profile of the U.S. population. That shift will substantially alter the balance between the population's working-age and retirement-age segments. The share of people age 65 or older is projected to grow from 13 percent in 2008 to 20 percent in 2035, while the share of people ages 20 to 64 is expected to fall from 60 percent to 55 percent. In later decades, the aging of the population will continue—but at a slower rate—because of increasing life expectancy.

For Social Security, aging of the population will drive the growth of spending as a share of GDP. Benefits are based on an individual's earnings and are indexed to wage growth, implying that program spending as a share of GDP is not very sensitive to overall economic growth. CBO projects that the number of workers per Social Security beneficiary will decline significantly over the next three decades: from about 3.1 in 2008 to 2.0 in 2035. Unless immigration, fertility, or mortality rates are markedly different than assumed in these projections, that number will continue to drift downward slightly after 2035.

Both aging and excess cost growth will push up federal spending for Medicare and Medicaid as a share of GDP because growing numbers of elderly people will need increasingly expensive health care. The rapid growth of health care costs in the past few decades is the starting point for projections of health care costs in the future. Since 1975, policy changes and other factors have caused annual costs per Medicare enrollee to grow an average of 2.3 percentage points faster than per capita GDP—a difference referred to as excess cost growth. Over the same period, excess cost growth for Medicaid has averaged 1.9 percent. (Those numbers reflect adjustments for changes in the age distribution of the beneficiary population.) In its long-term projections, CBO assumes that rates of spending growth for Medicare and Medicaid will moderate to some degree even if federal laws are not changed.[7]

Between now and 2035, an aging population—driven by both the retirement of the baby-boom generation and increases in life expectancy—explains 64 percent of spending growth in Medicare, Medicaid, and Social Security. It explains all of the growth in Social Security spending and 44 percent of the growth in spending on Medicare and Medicaid over that period.

In the long term, by contrast, growth in health care spending per beneficiary is a more important factor than population aging. Excess cost growth explains 56 percent of the projected growth in spending, as a percentage of GDP, on the three largest entitlement programs between now and 2080. It explains none of the projected growth in Social Security but 70 percent of that in Medicare and Medicaid. (For further discussion of the relationship between the aging of the population, rising health care spending, and federal outlays on Medicare, Medicaid, and Social Security, see Box 2.)

Spending for Social Security is identical under the assumptions of the extended-baseline and alternative fiscal scenarios, and spending for Medicaid is nearly identical. In the case of Medicare, however, the different assumptions underlying the scenarios lead to different views of the future path of spending. Because the extended-baseline scenario assumes that current law prevails, it anticipates that Medicare's sustainable growth rate mechanism will reduce payment rates for physicians by 21 percent in 2010 and then by a further 4 percent or 5 percent annually for at least the next few years. However, since 2003, the Congress has acted to prevent such reductions. Therefore, under the alternative fiscal

6. Those figures are net of premiums paid by Medicare beneficiaries and amounts paid by the states representing part of their share of the savings from shifting some Medicaid spending for prescription drugs to Part D of Medicare.

7. See "Underlying Assumptions for CBO's Projections of Health Care Spending" in Congressional Budget Office, *The Long-Term Budget Outlook* (June 2009), p. 28.

Box 2.

How the Aging of the Population and Excess Cost Growth Affect Federal Spending on Medicare, Medicaid, and Social Security

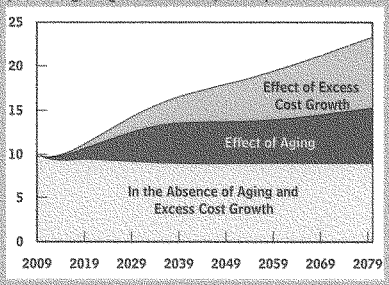
Two factors underlie the projected increase in federal spending on Medicare, Medicaid, and Social Security as a share of gross domestic product (GDP): rapid growth in health care costs per beneficiary and an aging population. Either of those factors alone would boost spending, but the two effects also compound, causing outlays to rise even faster.

To illustrate, the Congressional Budget Office (CBO) calculated how much of the projected increase in federal spending for Medicare, Medicaid, and Social Security would be attributable to aging and how much to "excess cost growth" (growth in age-adjusted health care costs per person that exceeds the growth of per capita GDP) under the extended-baseline scenario. CBO did so by comparing the outlays projected under that scenario with the outlays that would occur under two alternative paths: one with an aging population but no excess cost growth for health programs and one with no aging but with excess cost growth.[1]

The interaction between the aging of the population and excess cost growth accentuates their individual effects. Higher spending per person has a larger influence as the number of beneficiaries in Medicare and Medicaid rises. Conversely, having more beneficiaries in those programs imposes a larger budgetary cost when health care costs are growing. That interaction can be identified separately, or it can be allocated according to the shares attributable to aging and excess cost growth.

Factors Explaining Future Federal Spending on Medicare, Medicaid, and Social Security

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Aging is the more important factor over the next 25 years or so. If the interaction is allocated between the two factors, aging accounts for about 64 percent of the projected growth in spending on the major entitlements by 2035 (see the figure above and the table on the facing page). That result is not surprising because the aging of the baby-boom generation significantly expands the number of Medicare, Medicaid, and Social Security beneficiaries. Over the longer term, however, the situation reverses: 56 percent of the growth in total federal spending for those three programs by 2080 is attributable to health care costs per person rising more rapidly than per capita GDP. (Of course, the growth of health care costs has no direct effect on spending for Social Security.)

1. Several different approaches can be used to make those calculations. Two issues in particular arise in selecting the appropriate analytic method: what value of GDP to use when computing spending as a share of GDP, and how to construct spending under the base-case scenario. For a fuller discussion of those issues' importance in the context of spending for Medicare and Medicaid, see Congressional Budget Office, *Accounting for Sources of Projected Growth in Federal Spending on Medicare and Medicaid*, Issue Brief (May 28, 2008). The results shown here are based on approach 2 in that report. The current methodology allows GDP to vary with demographic changes in the population and attributes somewhat less of the spending growth to excess cost growth than would the methodology used in CBO's previous report, *The Long-Term Budget Outlook* (December 2007). In addition, more recent data on health care spending and other factors make excess cost growth slightly less important relative to the aging of the population than in CBO's earlier analysis.

Continued

Box 2. **Continued**

How the Aging of the Population and Excess Cost Growth Affect Federal Spending on Medicare, Medicaid, and Social Security

Identifying the interaction separately from the direct effects of aging and excess cost growth gives a slightly different perspective. By 2035, aging alone accounts for 56 percent of the projected growth in spending for the three entitlement programs. Excess cost growth accounts for another 32 percent, and the interaction between the two factors causes the remaining 11 percent. For the period through 2080, the picture changes, as aging accounts for 32 percent of the increase in spending, excess cost growth accounts for 41 percent, and the interaction effect contributes 26 percent.

Excess cost growth is the primary factor driving the growth of federal spending on Medicare and Medicaid, even over the intermediate term. By 2035, excess cost growth by itself accounts for 46 percent of projected growth in federal spending on those two programs. Adding in that factor's share of the interaction raises the contribution of excess cost growth to 56 percent. The figure for excess cost growth alone is similar in the long term and in the intermediate term (49 percent by 2080 and 46 percent by 2035). But with its share of the interaction included, excess cost growth is responsible for 70 percent of the projected growth in federal health care spending by 2080.

Explaining Projected Growth in Federal Spending on Medicare, Medicaid, and Social Security by 2035 and 2080, by Source

(Percent)

	Aging	Interaction	Excess Cost Growth
	Separating the Interaction		
	Medicare, Medicaid, Social Security		
2035	56	11	32
2080	32	26	41
	Medicare and Medicaid		
2035	37	16	46
2080	21	31	49
	Allocating the Interaction		
	Medicare, Medicaid, Social Security		
2035	64	n.a.	36
2080	44	n.a.	56
	Medicare and Medicaid		
2035	44	n.a.	56
2080	30	n.a.	70

Source: Congressional Budget Office.

Notes: Social Security has a larger effect on the share of spending growth attributable to aging than might be expected given the size of the program's spending relative to that of Medicare and Medicaid. Social Security spending as a share of GDP would decline relative to current levels if the 2010 age distribution of the population were to persist, because that distribution would imply a larger labor force and a smaller retiree population in the future.

n.a. = not applicable.

scenario, Medicare's physician payment rates are assumed to grow at the same rate as the Medicare economic index (which measures inflation in the inputs used for physicians' services). The difference in spending for Medicare under the two scenarios amounts to less than 1 percent of GDP throughout the projection period.

Although the trust funds for Medicare and Social Security would become insolvent under the extended-baseline and alternative fiscal scenarios, both scenarios assume that those two programs will continue to pay benefits as currently scheduled.[8] (Spending for some parts of Medicare comes from general funds with no connection to the trust funds, and Medicaid has no underlying trust fund.)

Other Federal Spending

A larger difference between the scenarios involves the assumption about federal spending for everything other than Medicare, Medicaid, Social Security, and interest on the public debt. In CBO's baseline, spending associated with stimulus legislation and efforts to stabilize the financial markets either expires under law or is explicitly assumed to be temporary and not to recur; most of the rest of the spending in this category increases roughly with inflation and thus shrinks as a share of GDP over the 10-year budget window. Therefore, in the baseline, such "other federal spending" (apart from the stimulus and related legislation) is 10.5 percent of GDP in fiscal year 2009 and 8.6 percent in fiscal year 2019.

Under the extended-baseline scenario, other federal spending remains at about 8.6 percent of GDP from 2020 onward—except for the declining impact of refundable tax credits. Under the alternative fiscal scenario, other federal spending follows the baseline through 2011 and remains close to 10.5 percent of GDP throughout the remainder of the projection period. That level roughly equals such spending in fiscal year 2009 minus spending associated with stimulus legislation and efforts to stabilize the financial system, which are assumed to be unusual, short-term undertakings.

8. The balances of those trust funds represent the total amount that the government is legally authorized to spend on each program. For a fuller discussion of the legal issues related to trust fund insolvency, see Congressional Research Service, *Social Security: What Would Happen If the Trust Funds Ran Out?* RL33514 (updated April 25, 2008).

The Outlook for Revenues

Like federal spending, revenues have been significantly higher in the past half-century than in previous eras. Since 1959, they have fluctuated between 16 percent and 21 percent of GDP, averaging about 18 percent. And just as spending priorities have changed during that period, the composition of revenues has shifted. Receipts from social insurance payroll taxes (for Social Security, Medicare, unemployment insurance, and retirement programs for federal civilian employees) have grown along with the size of the underlying programs, producing a larger share of total revenue. At the same time, the shares of revenue contributed by corporate income taxes and excise taxes have declined.

Federal revenues totaled 17.7 percent of GDP in fiscal year 2008. Because of the recession and the tax reductions provided in stimulus legislation, CBO expects revenues to decline sharply in fiscal year 2009, to 15.5 percent of GDP. However, under CBO's 10-year baseline, revenues are projected to rebound over the next decade as the economy improves, the tax cuts in EGTRRA and JGTRRA expire as scheduled, and a growing number of taxpayers become subject to the alternative minimum tax. As a result, revenues are projected to equal 19.6 percent of GDP in fiscal year 2012 and 20.1 percent in fiscal year 2015.

Under the extended-baseline scenario, revenues would continue to rise gradually thereafter, reaching 22 percent of GDP by 2035 and 26 percent by 2080. That increase occurs because real growth in income pushes people into higher income tax brackets over time. Moreover, inflation-related increases in income make more income subject to the AMT over time. As a result, the effective marginal tax rate on labor income would rise from 29 percent today to about 34 percent by 2035 and 35 percent by 2080. Average tax rates—that is, taxes as a share of income—would rise as well, and there would be a significant change in the way the overall tax burden was distributed among households. Under the extended-baseline scenario, the cumulative effects of inflation would make almost half of all households subject to the AMT by 2035 and nearly three-quarters subject to it by 2080. Currently, only 3 percent of households are subject to the AMT.

Under the alternative fiscal scenario, the expiring tax provisions in EGTRRA and JGTRRA would be extended, and the parameters of the AMT would be indexed to inflation after 2009. Consequently, revenues would grow more slowly over the long term than in the other scenario, but they would still increase gradually relative to GDP because of the effects of real income growth. The effective marginal tax rate on labor income would rise to about 30 percent in 2035 and to 33 percent in 2080. Tax receipts would reach only 18 percent of GDP in 2012 and then gradually rise to 22 percent of GDP by 2080, 4 percentage points lower than in the extended-baseline scenario.

The Accumulation of Federal Debt

For a path of spending and revenues to be sustainable, debt must eventually grow no faster than the economy. Persistent annual deficits lead to larger and larger amounts of debt, which in turn require more spending for interest payments on that debt. Thus, even moderate primary deficits (deficits excluding interest costs) can lead to unsustainable growth in federal debt.

A useful barometer of fiscal policy is the amount of government debt held by the public as a percentage of GDP. (For a discussion of why such debt is important, see Box 3.) That debt stood at 41 percent of GDP at the end of fiscal year 2008, a little above the 40-year average of 36 percent. CBO projects that in the next few years, deficits will be extraordinarily high by historical standards—almost 12 percent of GDP in fiscal year 2009 and almost 8 percent in fiscal year 2010. As a result, debt will grow to 60 percent of GDP by the end of fiscal year 2010.

Under the assumptions of the extended-baseline scenario, annual deficits would fall below 2 percent of GDP by fiscal year 2013. Debt would remain roughly stable as a share of GDP for the next decade. After that, however, growing spending on Medicare, Medicaid, and Social Security would lead to higher deficits, and debt would once again increase faster than the economy. By 2035, it would equal 79 percent of GDP. Federal debt peaked at 113 percent of GDP shortly after the end of World War II, a mark that would be passed in 2046 under the extended-baseline scenario.

Under the alternative fiscal scenario, deficits would decline for a few years after 2009 but then grow quickly again. By 2019, debt would reach 83 percent of GDP. After that, the spiraling costs of interest payments would swiftly push debt to unsustainable levels. Debt would exceed its historical peak of 113 percent of GDP by 2026 and would reach 200 percent of GDP in 2038.

Many budget analysts believe that the alternative fiscal scenario presents a more realistic picture of the nation's underlying fiscal policy than the extended-baseline scenario does—because, for example, it does not allow the impact of the AMT to expand substantially. To the extent that such a belief is valid, the explosive path of federal debt under the alternative fiscal scenario underscores the need for large and rapid corrective steps to put the nation on a sustainable fiscal course.

Moreover, CBO's projections understate the debt that would accumulate under the two scenarios. Long-term budget projections require a stable economic backdrop; thus, for the purpose of the projections, CBO made assumptions that generated a stable real interest rate and stable growth in real wages and output. In effect, the analysis omitted the pressures that a rising ratio of debt to GDP would have on real interest rates and economic growth. Changes in the demographic structure of the population are likely to offset somewhat the effects of high debt levels on real interest rates. In the end, however, ever-growing deficits and debt would lead to higher interest rates and slower economic growth.

The Economic Impact of Rising Federal Debt

The large amounts of federal debt that would accumulate under each of CBO's long-term budget scenarios imply that the government would have to spend increasing amounts to pay interest on that debt. The growth of debt would lead to a vicious cycle in which the government had to issue ever-larger amounts of debt in order to pay ever-higher interest charges. Eventually, the government would need to adopt some offsetting measures—such as

Box 3.

Why Is Federal Debt Held by the Public Important?

The federal government runs a budget deficit when its annual spending exceeds its annual revenues. To finance the shortfall, the government generally has to borrow funds from the public by selling Treasury securities (bonds, notes, and bills).[1] That additional borrowing increases the total amount of federal debt held by the public, which for the most part reflects the accumulation of past budget deficits offset by past budget surpluses.

Effects of Rising Debt Over Time

Debt held by the public can grow faster than gross domestic product (GDP) for a limited time, but it cannot do so indefinitely. If the ratio of debt to GDP continues to rise, lenders may become concerned about the financial solvency of the government and demand higher interest rates to compensate for the increasing riskiness of holding government debt. Eventually, if the debt-to-GDP ratio keeps increasing and the budget outlook does not improve, both foreign and domestic lenders may not provide enough funds for the government to meet its obligations. By then, whether the government resolves the fiscal crisis by printing money, raising taxes, cutting spending, or going into default, economic growth will be seriously disrupted.

1. In most years, the amount of debt that the Department of the Treasury borrows or redeems roughly equals the annual budget deficit or surplus. However, the correspondence is not exact because a small amount of the deficit can also be financed by changes in other means of financing (such as reductions or increases in the government's cash balance, costs included in the budget but not yet paid, and cash flows reflected in credit financing accounts). In addition, transactions involving the Troubled Asset Relief Program, assistance for Fannie Mae and Freddie Mac, and purchases by the Treasury of mortgage-backed securities will have a significant effect on the federal government's cash flows in 2009 and for many years to come. However, because the transactions are generally assumed to be completed by 2019, they play no significant role in the Congressional Budget Office's long-term projections of the deficit.

Another measure of federal indebtedness that often receives attention is gross debt, but it is not useful for assessing how the Treasury's operations affect the economy. Gross federal debt comprises both debt held by the public and debt issued to various accounts of the federal government, including the major trust funds in the budget (such as those for Social Security). Because the debt issued to those accounts is intragovernmental, it has no direct, immediate impact on the economy. Instead, it simply represents credits to the various government accounts that can be redeemed as necessary to authorize payments for benefits or other expenses. Although the Treasury assigns earnings in the form of interest to the trust funds that hold the securities, such payments have no net effect on the budget.

Long-term projections of federal debt held by the public, measured relative to the size of the economy, provide useful yardsticks for assessing the sustainability of fiscal policies. If budget projections are carried out far enough into the future, they can show whether current commitments imply that spending will consistently exceed revenues and produce debt that grows faster than the economy. Projections of the debt-to-GDP ratio can thus indicate that changes in current policies will be necessary at some point to bring the federal budget back to a sustainable path.

Historical and International Comparisons of Debt

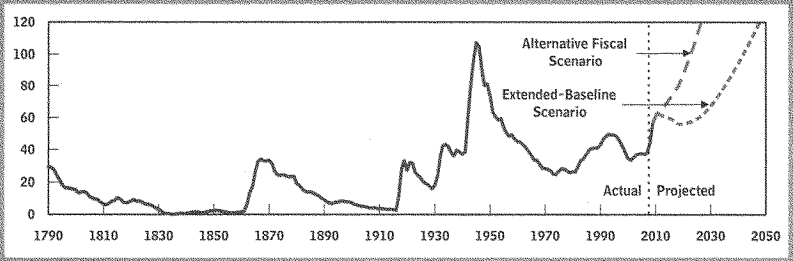
The deficits and debt projected under the Congressional Budget Office's (CBO's) two long-term budget scenarios are large, whether compared with those in U.S. history or in other countries. Under the extended-baseline scenario, federal debt held by the public would reach 79 percent of GDP in 2035, and the annual deficit would exceed 10 percent of GDP starting in 2058. Under the alternative fiscal scenario, federal debt held by the public would rise even faster, to 181 percent of GDP in 2035, and annual deficits

Continued

Box 3. Continued

Why Is Federal Debt Held by the Public Important?

Federal Debt Held by the Public as a Percentage of Gross Domestic Product



Source: Congressional Budget Office.

would exceed 10 percent of GDP beginning in 2027. (For deficit and debt comparisons under the two scenarios, see Figure 1-2 and Table 1-2.)

Since the founding of the United States, the budget deficit has exceeded 10 percent of GDP in only a few instances, usually during or following major wars. (CBO anticipates that this year's deficit will also exceed 10 percent of GDP.) Moreover, federal debt held by the public has surpassed 100 percent of GDP only for a brief period during and just after World War II (see the figure above). That budgetary situation was temporary, however. After peaking at 113 percent in 1945, federal debt held by the public declined as a percentage of GDP to its lowest level in the post-World War II era, 24 percent in 1974. Similarly, when federal debt increased in the 1980s, its rise was followed by declining deficits from 1993 to 1997 and surpluses from 1998 through 2001. The systematic widening of budget shortfalls projected under CBO's long-term scenarios has never been observed in U.S. history.

International comparisons show that the debt projected for the United States under CBO's two scenarios would also be greater than the amounts that other industrialized nations have accumulated in the post-World War II period. Among developed countries, Belgium and Italy carried net debt amounting to more than 100 percent of their GDP in the 1990s. Net public debt averaged about 103 percent of GDP in Italy and 110 percent in Belgium during the second half of the 1990s.[1] However, those two countries' experience involved debt that, relative to GDP, later fell modestly in the case of Italy (to 88 percent in 2007) and dropped significantly in the case of Belgium (to 73 percent in 2007). In both countries, debt did not grow continually faster, as is projected under CBO's long-term scenarios. Even so, to keep their debt under control, those governments had to make significant changes in fiscal policy to stop the upward trend in the growth of debt relative to GDP. Japan saw its net public debt steadily increase during the past two decades, from 13 percent in 1991 to 86 percent in 2007. To slow that increase, the government managed to reduce annual budget deficits from 8 percent of GDP in 2002 to 4 percent in 2007. Even so, the Organisation for Economic Co-operation and Development has urged Japan to go further to promote fiscal sustainability by cutting government spending and raising revenues.[2]

1. Organisation for Economic Co-operation and Development, *Economic Outlook* (Paris: OECD, December 2008).

2. Organisation for Economic Co-operation and Development, *Economic Survey of Japan, 2008* (Paris: OECD, April 2008).

cutting spending or increasing taxes—to break the cycle and put the federal budget on a sustainable path.[9]

If the long-term outlook for the budget appears sustainable, temporary deficits for a few years do not create large economic problems and can have significant benefits in some circumstances. For example, a deficit that results from automatic declines in tax revenues or increases in government spending in a recession (due to reductions in economic activity and more people losing jobs) helps reduce the severity of the downturn, and such a short-term budgetary imbalance will be reversed when the economy recovers. In addition to automatic changes, deficit-financed fiscal stimulus—such as the tax rebates in the Economic Stimulus Act of 2008 (Public Law 110-185) and the spending increases and tax cuts in the American Recovery and Reinvestment Act of 2009 (P.L. 111-5)—can also help the economy return to full employment.[10] Thus, the ability of the federal government to run budget deficits enables fiscal policy to offset some of the negative impact of a recession. However, even temporary deficits cause an increase in debt that crowds out productive capital and reduces output in the long run (assuming that the government does not run budget surpluses later to retire the additional debt).

Moreover, the fundamental cause of the rapidly rising debt in CBO's long-term scenarios is not economic fluctuations resulting from business cycles. Instead, debt soars because of unrelenting growth in federal spending on health care programs and a rise in Social Security spending as a share of GDP, combined with a much smaller increase in tax revenues. The ever-greater budget deficits projected under those scenarios would negatively affect the economy through several channels. More government borrowing would drain the nation's pool of savings, reducing investment in the domestic capital stock and in foreign assets. In addition, a worsening fiscal situation might put pressure on monetary policy, potentially endangering the Federal Reserve's ability to keep inflation low and stable. If the budget continued along the path of rising debt, serious concerns about fiscal solvency would arise. Investors would require the government to pay an interest premium on its securities to compensate for the risk that they might not be repaid or that the value of their securities would be eroded by inflation. Such a premium would drive up the cost of borrowing. Finally, the longer the growth of debt persisted, the larger and more costly would be the policy changes needed to control debt, which could further increase the burden of fiscal tightening on future generations.

Most economists agree that greater government borrowing would raise interest rates and lead to greater private saving. But the offset would be far from complete, so national saving would decline.[11] That decline would in turn reduce investment in the United States but not on a one-for-one basis (at least initially), because higher interest rates would attract foreign capital to the United States and perhaps induce U.S. investors to keep more of their money at home. As investment was displaced by government debt, GDP would grow more slowly and eventually decline. In the longer run, as the debt continued to grow and unless the interest premium was very large, capital would probably flee the United States, further reducing investment.

To quantify the effect of rising federal debt projected under the two long-term scenarios, CBO applied a "textbook" growth model.[12] The textbook growth model assumes that part of the deficit is financed from abroad (and ignores the likelihood of capital flight). Therefore, some portion of GDP would have to be sent abroad to

9. The government would have trouble issuing ever-increasing amounts of debt relative to GDP forever because there is a limit to the amount that savers want to save. If federal debt grew faster than the maximum rate at which savers were willing to acquire that debt (in the form of Treasury securities), government policies would be unsustainable. To regain sustainability, the growth rate of the market value of debt would have to decline enough that savers or investors would be willing to acquire more Treasury securities. That growth rate could be reduced in a number of ways: Debt could lose its market value through increases in the general price level or decreases in the prices of long-term bonds, or the government could reduce budget deficits.

10. See Congressional Budget Office, "Estimated Macroeconomic Impacts of the American Recovery and Reinvestment Act of 2009," letter to the Honorable Charles E. Grassley (March 2, 2009).

11. National saving is private saving plus public saving by state, local, and federal governments. (Public saving equals surpluses minus deficits; therefore, surpluses add to public saving and deficits subtract from it.)

12. For a description of the textbook growth model, see Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2010* (June 2009), Appendix B.

service or repay that debt and thus would not be available to U.S. consumers. For that reason, the economic analysis that follows focuses on what happens to gross national product—which measures the income of U.S. residents after deducting net payments to foreigners—rather than the more familiar GDP. (The level of GNP is currently not much different from that of GDP.)

Effects Under the Extended-Baseline Scenario

Under the extended-baseline scenario, federal debt would rise substantially after the 2020s. According to the textbook growth model, the debt projected under that scenario would reduce the capital stock by about 5 percent in 2035 and shrink real GNP by about 2 percent, compared with what they would be if debt remained roughly at its 2008 share of GNP (by keeping the spending and revenue shares of GNP at roughly their 2008 levels). By 2080, federal debt would approach 300 percent of GNP, and the capital stock would be reduced by nearly 40 percent and real GNP by almost 20 percent.

Such estimates are based on the assumption that the government would continue on the unsustainable budget path as projected under the extended-baseline scenario. The analysis mainly focuses on the effect of soaring federal deficits and debt. It does not incorporate the financial markets' reactions to a fiscal crisis and the actions that the government would adopt to resolve such a crisis. Because the textbook growth model is not forward-looking, the analysis assumes that people will not anticipate the sustainability issues facing the federal budget; as a result, the model predicts only a gradual change in the economy as federal debt rises.

In actuality, the economic effects of rapidly growing debt would probably be much more disorderly as investors' confidence in the nation's fiscal solvency began to erode. If foreign investors anticipated an economic crisis, they might significantly reduce their purchases of U.S. securities, causing the exchange value of the dollar to plunge, interest rates to climb, and consumer prices to shoot up. Amid the anticipation of declining profits and of rising inflation and interest rates, stock prices might fall, and consumers might sharply curtail their purchases. In such circumstances, the economic problems in the United States would probably spill over to the rest of the world, seriously weakening the economies of U.S. trading partners. All in all, the U.S. economy could contract sharply for a long period.

Theoretically, one way to reduce government indebtedness would be to adopt a policy of higher inflation. That approach would lower the real value of the government's debt and provide relief in the short run. But printing money is not a feasible long-term strategy for dealing with persistent and rising debt. Although an unexpected increase in inflation would let the government repay its debt in cheaper dollars for a short time, financial markets would not be fooled for long, and investors would demand higher interest rates going forward. If the government continued to print money to reduce the value of the debt, the policy would eventually lead to hyperinflation (as occurred in Germany in the 1920s, Hungary in the 1940s, Argentina in the 1980s, Yugoslavia in the 1990s, and Zimbabwe today). Such hyperinflation would severely reduce economic efficiency as people moved away from monetary transactions.

Moreover, even if inflation was eventually brought back under control, the resulting loss of confidence would keep interest rates elevated for some time. High inflation causes governments to lose credibility in financial markets; once that credibility has been lost, lowering expectations about inflation can be difficult. In the end, printing money to finance deficits cannot address the fundamental problem that spending exceeds revenues.

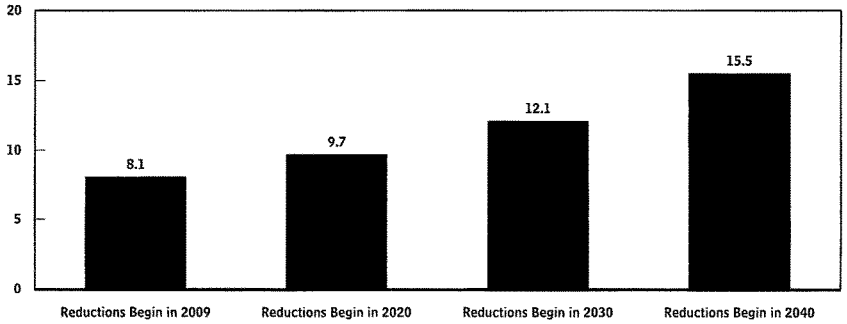
Effects Under the Alternative Fiscal Scenario

In CBO's analysis, federal debt would rise much more steeply under the alternative fiscal scenario, reducing the capital stock in 2035 by more than 20 percent compared with what it would be if the deficit stayed at roughly its 2008 level as a share of GNP. According to the estimates of the textbook growth model, that reduction in the capital stock and increased indebtedness to foreigners would in turn lower real GNP in 2035 by about 9 percent. Losses to the U.S. economy would grow rapidly thereafter. By 2045, rising federal debt would reduce the capital stock by more than 35 percent and real GNP by about 16 percent. (Starting in the 2060s, projected deficits become so large and unsustainable that CBO's textbook growth model cannot calculate their effects.) Even more than in the extended-baseline scenario, economic disruption could occur much sooner than

Figure 4.

Reductions in Noninterest Spending Needed to Close the Fiscal Gap in Various Years Under CBO's Alternative Fiscal Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: The fiscal gap is a measure of federal shortfalls over a given period. It represents the extent to which the government would need to immediately and permanently either raise tax revenues or cut spending—or do both, to some degree—to make the government's debt the same size (in relation to the economy) at the end of that period as it was at the beginning.

The alternative fiscal scenario deviates from CBO's baseline projections, beginning in 2010, by incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

projected by the textbook growth model if investors and others came to expect future budgetary deterioration.

What Are the Costs of Delaying Action on the Budget?

The choice facing policymakers is not whether to address rising deficits and debt but when and how to do so. Debt is projected to soon grow to unsustainable levels even under the extended-baseline scenario, which assumes that spending on programs other than Medicare, Medicaid, and Social Security will decline substantially (relative to GDP) over the next 10 years and that revenues will increase as a percentage of GDP over the long term from their average historical levels. Under the alternative fiscal scenario, debt is projected to soar almost immediately.

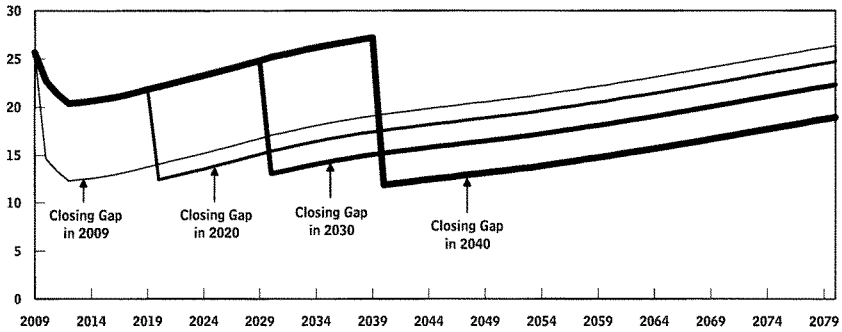
Reducing the growth of the major entitlement programs—Social Security, Medicare, and Medicaid—would go a long way toward lowering the projected levels of debt relative to GDP. The aging of the population has the most significant impact on entitlement costs over the intermediate term, but policymakers have little control over such demographic changes. However, policy changes that altered the eligibility age for programs or modified benefits for the elderly could help offset some of the effects of aging on federal spending. In the long run, the growth of health care spending per beneficiary will drive federal entitlement spending. It would be difficult to produce a sustainable fiscal policy without reducing such spending growth.[13]

13. In December 2008, CBO released two reports that are intended to help the Congress as it contemplates possible changes—both large and small—to federal health programs and the nation's health insurance and health care systems: *Key Issues in Analyzing Major Health Insurance Proposals* and *Budget Options, Volume 1: Health Care*.

Figure 5.

Noninterest Spending Under Various Assumptions About Closing the Fiscal Gap in CBO's Alternative Fiscal Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: The fiscal gap is a measure of federal shortfalls over a given period. It represents the extent to which the government would need to immediately and permanently either raise tax revenues or cut spending—or do both, to some degree—to make the government's debt the same size (in relation to the economy) at the end of that period as it was at the beginning.

The alternative fiscal scenario deviates from CBO's baseline projections, beginning in 2010, by incorporating some changes in policy that are widely expected to occur and that policymakers have regularly made in the past.

The longer that policy action on the budget is put off, the more costly and difficult it will be to resolve the long-term budgetary imbalance. Delays in taking action would create three major problems:

- The amount of government debt would rise, which would displace private capital—reducing the total resources available to the economy—and increase borrowing from abroad.

- The share of federal outlays devoted to paying interest on the federal debt would grow, so lawmakers would have to make ever-larger policy changes to achieve balance. As interest costs rose, policymakers would be less able to pay for other national spending priorities and would have less flexibility to deal with unexpected developments (such as a war or recession). Moreover, rising interest costs would make the economy more vulnerable to a meltdown in financial markets.

- Uncertainty about the economy would increase. The longer that action was put off, the greater the chance that policy changes would ultimately occur suddenly, possibly creating difficulties for some individuals and families, especially those in or near retirement. Announcing changes to entitlement programs or to the tax structure well in advance would give people time to adjust their plans for saving and retirement. Those adjustments could significantly reduce the impact of such policy changes on people's standard of living.

CBO's simulations indicate that under the alternative fiscal scenario, postponing action could substantially increase the size of the policy adjustments needed to put the budget on a sustainable course. If policymakers wanted to close the fiscal gap in 2020 by altering spending (and economic effects were ignored in the calculation), they would have to reduce noninterest outlays permanently by 10 percent of GDP (see Figure 4). If they waited until 2040 to close the fiscal gap, they would have to reduce noninterest outlays permanently by almost 16 percent of GDP (see Figure 5). Incorporating the effects of deficits and debt on economic growth (which are excluded from these simulations) would make the impact of delaying policy changes even more severe.

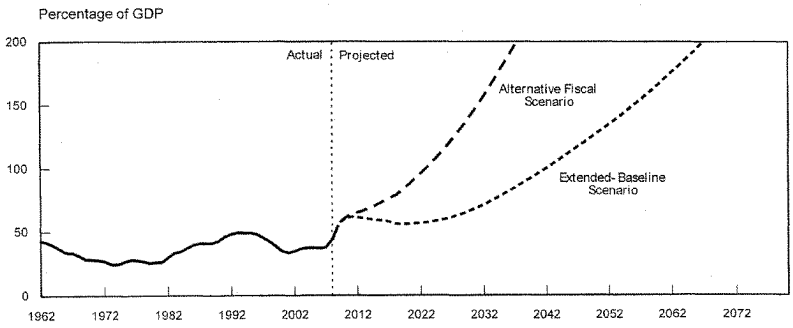
Congressional Budget Office

The Long-Term Budget Outlook

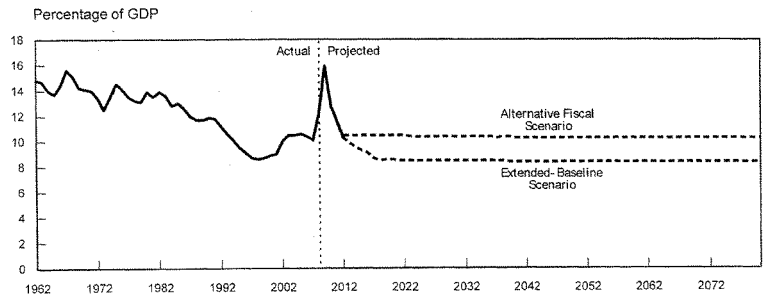
Douglas W. Elmendorf
Director

July 16, 2009

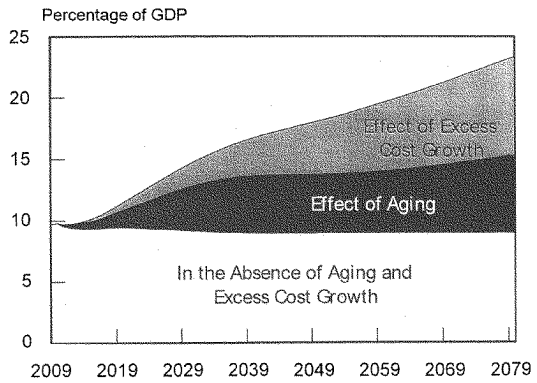
Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios

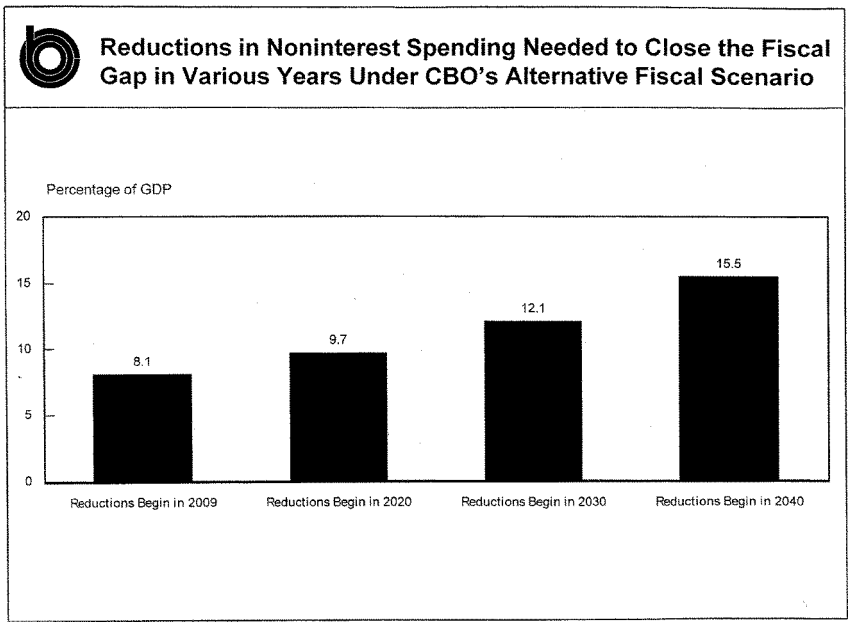


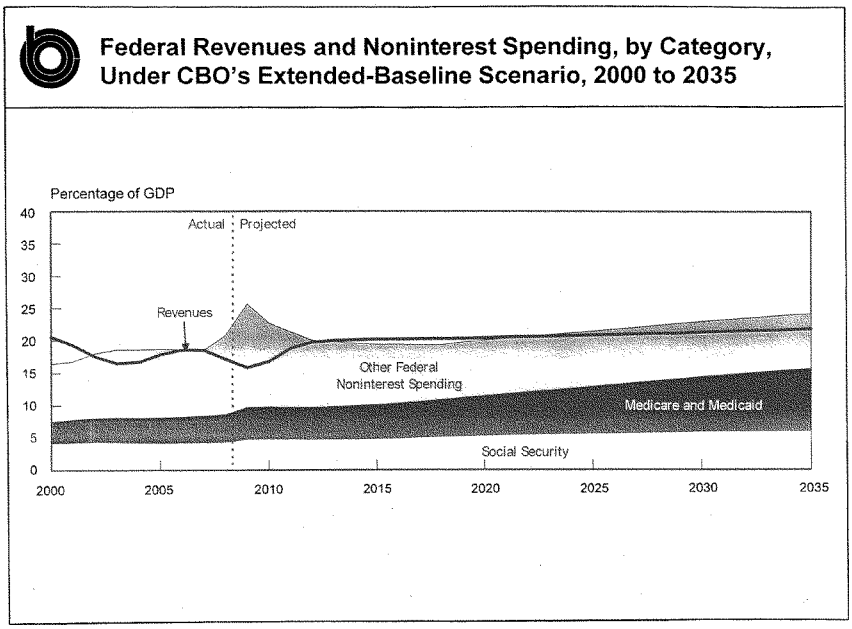
Spending Other Than That for Medicare, Medicaid, Social Security, and Net Interest, 1962 to 2080



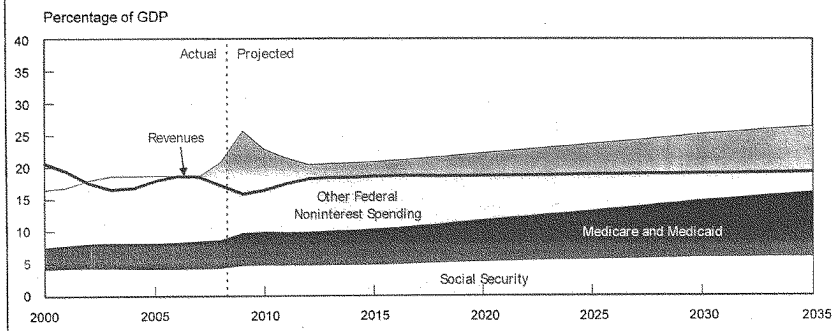
Factors Explaining Future Federal Spending on Medicare, Medicaid, and Social Security



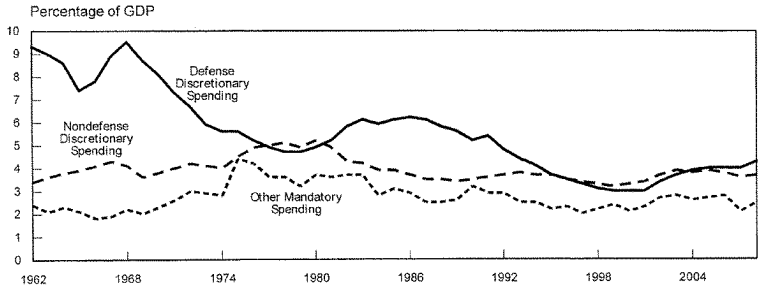

Reductions in Noninterest Spending Needed to Close the Fiscal Gap in Various Years Under CBO's Alternative Fiscal Scenario
Percentage of GDP
20
15
10
5
0
8.1
9.7
12.1
15.5
Reductions Begin in 2009
Reductions Begin in 2020
Reductions Begin in 2030
Reductions Begin in 2040

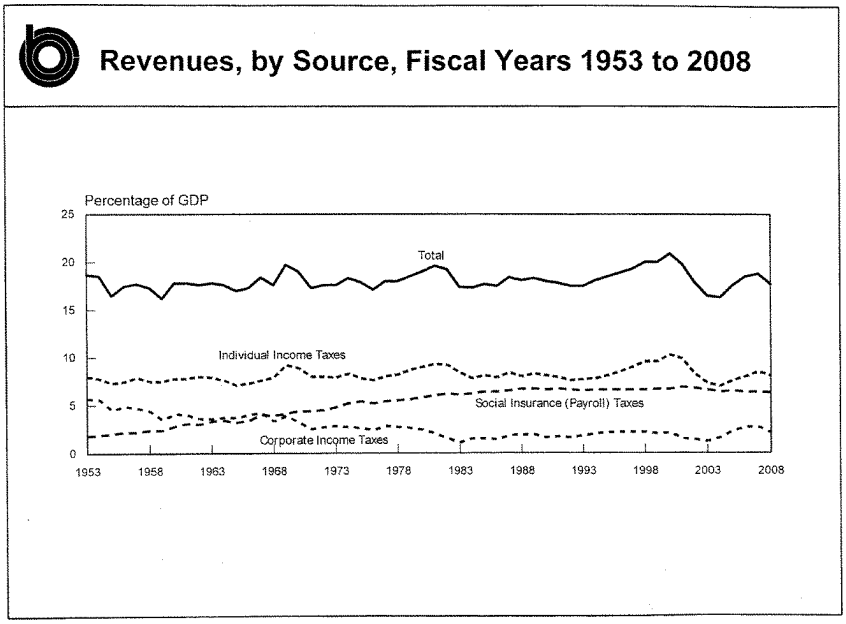

Federal Revenues and Noninterest Spending, by Category, Under CBO's Extended-Baseline Scenario, 2000 to 2035
Percentage of GDP
40
35
30
25
20
15
10
5
0
Actual
Projected
Revenues
Other Federal Noninterest Spending
Medicare and Medicaid
Social Security
2000
2005
2010
2015
2020
2025
2030
2035

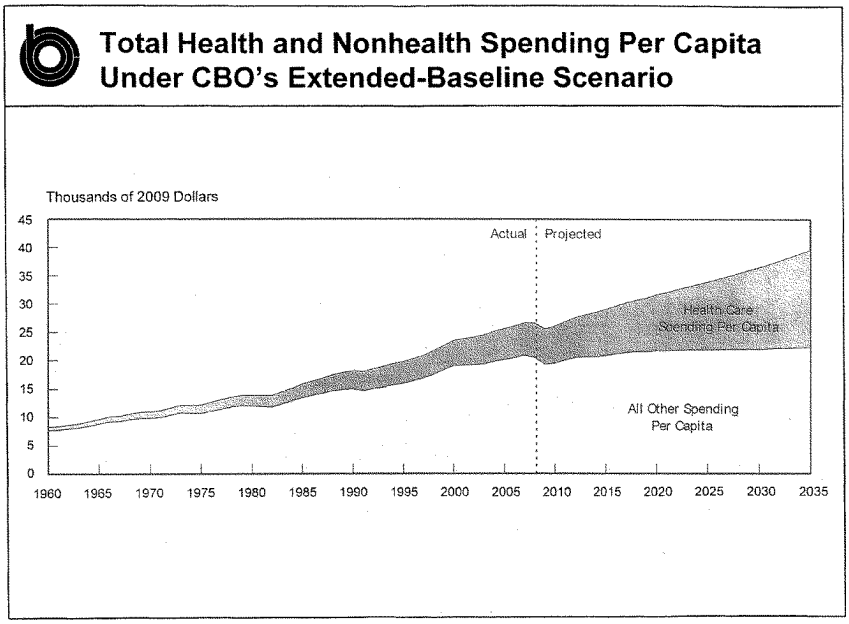
Federal Revenues and Noninterest Spending, by Category, Under CBO's Alternative Fiscal Scenario, 2000 to 2035



Discretionary Spending and Mandatory Spending Other Than That for Medicare, Medicaid, Social Security, and Net Interest, Fiscal Years 1962 to 2008







Chairman CONRAD. Dr. Elmendorf, I am going to really put you on the spot because we are in the middle of this health care debate, but it is critically important we get this right.

Everyone has said—virtually every one—that bending the cost curve over time is critically important and one of the key goals of

this entire effort. From what you have seen, from the product of the committees that have reported, do you see a successful effort being mounted to bend the long-term cost curve?

Mr. ELMENDORF. No, Mr. Chairman. In the legislation that has been reported, we do not see the sort of fundamental changes that would be necessary to reduce the trajectory of Federal health spending by a significant amount. And, on the contrary, the legislation significantly expands the Federal responsibility for health care costs.

Chairman CONRAD. So the cost curve, in your judgment, is being bent, but it is being bent the wrong way. Is that correct?

Mr. ELMENDORF. The way I would put it is that the curve is being raised, so there is a justifiable focus on growth rates, because, of course, it is the compounding of growth rates faster than the economy that leads to these unsustainable paths.

It is very hard to look out over the very long term and say very accurate things about growth rates. So most health experts that we talk with focus particularly on what is happening over the next 10 or 20 years, still a pretty long time period for projections. They focus on the next 10 or 20 years and look at whether efforts are being made that are bringing costs down or pushing costs up over that period.

As we wrote in our letter to you and Senator Gregg, the creation of new subsidies for health insurance, which is a critical part of expanding health insurance coverage, in our judgment, would by itself increase the Federal responsibility for health care. That raises Federal spending on health care, which raises the amount of activity that is growing at this unsustainable rate. And to offset that, there would have to be very substantial reductions in other parts of the Federal commitment to health care, either on the tax revenue side through changes in the tax exclusion, or on the spending side, through reforms in Medicare and Medicaid. Certainly reforms of that sort are included in some of the packages, and we are still analyzing the reforms in the House package, which was only released, as you know, about 2 days ago.

But the changes that we have looked at so far do not represent the sort of fundamental change on the order of magnitude that would be necessary to offset the direct increase in Federal health costs from the insurance coverage proposals.

Chairman CONRAD. And what about the Finance Committee package as it stands?

Mr. ELMENDORF. I cannot speak to that, Mr. Chairman. We have been working with the Finance Committee and the staff for a number of months on proposals that they have been addressing, but our consultations with them have been confidential because they have not yet released legislation. And I do not want to speak publicly about that.

Chairman CONRAD. All right. And in terms of those things that are public from the other plans, what are the things that are missing that, in your judgment, prevent a bending of the cost curve in the right way?

Mr. ELMENDORF. Bending the cost curve is difficult. As we said in our letter to you, there is a widespread consensus—and you quoted some of this—that a significant share of health spending is

not contributing to health. But rooting out that spending without taking away spending that is beneficial to health is not straightforward. Again, the way I think experts would put it, the money is out there, but it is not going to walk in the Government's door by itself. And devising the legislative strategies and the regulatory changes that would generate these changes is not straightforward. But the directions that have widespread support among health analysts include changing the preferential tax treatment of health insurance. We have a subsidy for larger health insurance policies in our Tax Code, and that, like other subsidies, encourages more of that activity. Reducing that subsidy would reduce that.

And on the other side, changing the way that Medicare pays providers in an effort to encourage a focus on cost-effectiveness in health care and not encourage, as the fee-for-service system tends to, the delivery of additional services because bills for that will be paid.

Chairman CONRAD. I thank you. Senator Gregg.

Senator GREGG. Picking up there, Director, because I think you have stated rather precisely the fact that what we have done so far has not gotten to the problem, or what has been proposed so far is not getting to the problem, and you have made a very good case for the need to look at the deductibility of health insurance and the perverse incentives that creates for very high end plans that create overutilization, to say nothing of the fact that it is low-income people subsidizing high-income people's insurance.

Mr. ELMENDORF. Yes, sir.

Senator GREGG. But I want to get to the issue which you essentially stated. The problem is, going forward, the cost of Medicare and Medicaid to the Government. And if we create this new subsidy for basically the uninsured, I presume that will also get folded in as one of the problems relative to driving costs.

The question becomes: What procedures can be put in place that are going to affect the Medicare reimbursement system and the Medicaid reimbursement system in a way that will cause us to continue to get quality health care, but get it at a more affordable price?

Now, there have been a number of proposals put forward. I don't know how many of them you have had a chance to look at in specific, but let me list a few and get your thoughts on them. I will list them and then you can go through them.

The first, of course, is to reduce defensive medicine, which means tort reform.

The second is the issue of encouraging people to pursue healthy lifestyles through incentivizing them with reimbursements, cash basically, by expanding HIPAA, the 20 percent to 50 percent or something.

Third is changing the incentives for providers relative to delivering services so that you reward economically providers who are scored as delivering quality services at lower costs.

Fourth is addressing the issue of the last 6 months of life through a shared responsibility approach, which has been introduced by myself and discussed at length by others.

And fifth is an idea that has been just recently put on the table—and I don't know if you are familiar with it—by the folks up

at Dartmouth where they are taking their numbers and converting them to clinical trials, so to say, as ways to control health care costs by picking—I think their proposal is to pick three major delivery systems in this country, try to systematize what they do that delivers good quality at lower cost, and then grow out from there by bringing other systems into that and start picking up systems that aren't quite as effective and bring them into the realm of what these systems do. They tend to think that that proposal, which is a huge demonstration program growing into a national program, but doing it in a way that is orderly as versus just pushing everybody into the program, is the best way to proceed.

Can you give me your evaluation of those ideas and any other specific ideas that we should do in the area of Medicare reform relative to the way we encourage people to buy insurance and to deliver insurance that you think would actually specifically affect the out-year cost curve?

Mr. ELMENDORF. OK. I will try to address those questions in turn.

First, on defensive medicine, CBO's evaluation of the evidence of the effect of tort reform in different States is that it has reduced costs directly through less payment in malpractice cases, but that it has not had the spillover effects one would have expected in terms of medical practice more widely.

Now, Senator Hatch gave me a good talking-to before the HELP Committee about what he viewed as the ridiculousness of that evaluation, and he speaks with some experience in this area, and I assured him that we would look at the issue carefully.

I think our interpretation of the evidence we have seen is not that defensive medicine is such a problem, but that even the sorts of tort reforms that have been undertaken turned out not to be very effective at stopping defensive medicine.

Senator GREGG. Is there another way to get at defensive medicine?

Mr. ELMENDORF. I do not know of one. I think it is probably related to the general litigiousness of our society and attitudes about that. But I don't know, and I am not an expert in that area.

On your second point about healthy lifestyles, a leading health economist, a member of CBO's panel of health advisers, said to me a few months ago that the thing that truly scares him most about future health costs in this country is obesity. And if you look at the chart—and we have shown this—of the incidence of tobacco use in this country, it has gone like this over the last several decades. The incidence of obesity is essentially a mirror image of that.

The challenge is developing the policies that can address that. Tobacco is a single substance, already controlled and regulated by the Government, and it has taken several decades to have this effect.

Now, in the end, I think social changes and policy changes have had a very pronounced effect, but it took some time.

Obesity is more complicated because there are many factors that contribute to it: lifestyle in terms of exercise, but also lifestyle in terms of diet and lots of different types of foods, of course. It is a harder problem to get at.

But certainly incentives are undoubtedly an important part of that solution, and I think that direction is a useful one to go in, and I think it would be a view that experts would widely share. It will take some time, but it is very important, again, in the view of all the experts we have talked with, to get started on that process.

Incentives for providers are, again, key here. Incentives matter in the world, and when we pay doctors per service performed, undoubtedly that leads to more services performed than if they were paid in different ways.

But changing behavior is still complicated. If one pays doctors too little for a procedure, then they may do too few of them. So there is a balance. And we know from the performance of certain health systems around the country it is possible to deliver very high quality care at much lower cost than average. So exporting those systems to other parts of the country whose medical systems operate in different ways is challenging.

So I think changing incentives for providers is certainly the right direction to go in as well, and we have analyzed in our budget options volume some ways to do that. But there will have to be some experimentation, and I will come back to that at the end.

Your fourth point was about the last 6 months of life. I think this is the question I have been asked most often about health care since I have been the Director at CBO, to which we really don't have any answer. We have not done work in this area, and we should and we will, because as everyone knows, the distribution of medical spending is very skewed toward particular people, and an awful lot of medical spending happens in what turns out to be the last year of people's lives—or the last 6 months of people's lives.

Again, finding a balance, nobody wants to be told to stop getting certain kinds of treatment. I think it is a matter of informing patients. My father is somebody who was in that position a few years ago, and he was able to make decisions based on information from his doctor, and I am very grateful for that. And I think that can be very important. But we have not done much work on that area.

The experimentation you describe with different delivery systems, is absolutely central. As we wrote in our letter to you and Senator Conrad, many of the specific changes that might ultimately prove most important cannot be foreseen today, and can be developed only over time through experimentation and learning. And that is a way, I think, of discovering what is it that makes certain health care systems work much better than others.

In terms of what else there is on the agenda, I think something you may have alluded to but has not gotten a lot of attention in the discussion of the last few months is greater cost-sharing responsibility for individual patients. And, again, CBO has analyzed in its budget options volume last December a number of ways of changing the cost-sharing structure in Medicare.

It is a challenge because, of course, the point of insurance is to insulate people from unbearable costs. But it is possible to design cost-sharing systems in which individuals bear some of the costs at a reasonable level, enough to make them sensitive to the costs of alternative strategies for addressing medical problems, and without leaving them open to the catastrophic costs of treatment that might

ensue. And I think with care, movement in that direction can be a very important complement to providing different incentives to providers.

Senator GREGG. Thank you, Mr. Chairman.

Chairman CONRAD. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman, and, Dr. Elmendorf, my thanks to you as well for your professionalism and your responsiveness to all of us.

I want to go at this set of tax rule questions a little bit differently. It is pretty obvious if you go out to a group of working-class people and say, "How would you feel about having your health care taxed?" about 107 percent say, "No way," usually accompanied by some pretty choice curse words before the words "No way."

If, however, you say to them, "You know, these tax rules look like they go mostly to the well-off and we are interested in trying to come up with a way that will give you working-class people a tax break and help us to hold down costs," people say, "You know, I am interested in looking at that."

Now, 14 United States Senators, a big bipartisan group, have essentially proposed that, and I just want to go over with you what the findings I believe are between you all and also Joint Tax.

What you all and Joint Tax have essentially said is if you convert these tax rules into something that provides a generous, fixed, above-the-line credit or deduction, three good things happen:

One, you provide a tax cut, a significant one—and Joint Tax says this—to more than 35 million working-class people.

Second, what you all have said is that that kind of approach—and I am looking at page 35 of the budget materials—excuse me, at one of your charts on the budget. You all say that it would also provide an incentive to contain costs.

And, third, that we would have a substantial amount of money left over to try to boost the transition to covering the uninsured.

Do you share that kind of analysis that I have just made this morning?

Mr. ELMENDORF. Yes, I do, Senator.

Senator WYDEN. OK. On the second point, following up on what Chairman Conrad has said—and I know Senator Gregg is concerned about this as well—people around the country are being told that these bills that are coming out of the Senate and coming out of the House are going to lower their premiums. And I am trying to figure out what is in these bills that will lower their premiums, and I cannot find very much.

Can you tell me what we would say to our constituents on this central point of lowering premiums if these bills pass in their current form?

Mr. ELMENDORF. So these bills differ in a variety of ways that can be important, as you know. Let me mention a few general features of some of the reform proposals we have seen that can affect premiums, affect private insurance premiums.

The first is that for people who are currently buying insurance in the individual or non-group market, where there are very large administrative loads and adverse selection problems, the creation of exchanges with a mandate to buy insurance which draws people

in and insurance reforms around guaranteed issue of policies and elimination of pre-existing condition restrictions and so on, those sorts of reforms can reduce premiums for those people, partly by avoiding the adverse selection problems, partly because in some of these proposals that try to adjust for the risk in different insurance plans, money is moved around in a way that reduces the incentive for insurance plans to cherrypick and to figure out what costs they can avoid paying.

So there are administrative savings through these exchanges, and there is some greater competition through these exchanges. And that we think we would have some effect on reducing premiums for those people.

Additionally, these reforms can have effects on private insurance premiums through shifting of costs from public plans, but there are forces cutting in different directions there. I don't think there is a clear sign of that effect in the end, and, actually, CBO's reading of the evidence is that cost shifting is a much less quantitatively important phenomenon than most observers think. And there are some other features as well, but I think it is fair to describe these as fairly small effects relative to the level and trajectory of private health insurance premiums.

Senator WYDEN. Mr. Chairman, my time is about up but there was a very important article printed yesterday by Kaiser that said, and I will just quote the title: "For many workers, insurance choices may be limited." And so what Dr. Elmendorf has said—and I share his view—is that down the road there is going to be some real cost containment potential in the exchanges, if workers can get to them. But what Kaiser has just pointed out—and I would just ask unanimous consent that this be put into the record, Mr. Chairman.

Chairman CONRAD. Without objection.

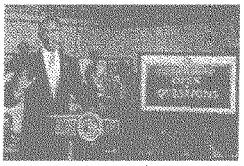
[The article follows:]

KHN: Kaiser Health News

For Many Workers, Insurance Choices May be Limited

Topics: Health Reform, Insurance

By Mary Agnes Carey and Julie Appleby
Jul 15, 2009



President Obama and leading Democrats have stressed that people who like their employer-sponsored insurance would be able to keep it, under a health care overhaul. But they haven't emphasized the flip side: That people who don't like their coverage might have to keep it.

Under the main health bills being debated in Congress, many people with job-based insurance could find it difficult to impossible to switch to health plans on a new insurance exchange, even if the plans there were cheaper or offered better coverage. The restrictions extend to any government-run plan, which would be offered on the exchange.

The provisions could change, and there are a few exceptions: Workers would be allowed to buy insurance through the exchange if their job-based coverage gobbled up too much of their incomes or was too skimpy. Also, under the House proposal, people could get insurance through the exchange if they paid their entire premiums— a cost that would be prohibitive for many workers.

Democratic lawmakers and administration officials say the restrictions are critical to maintaining a strong employer-based insurance system, which covers 158 million Americans.

But critics argue that the rules run counter to suggestions from health care reform advocates that an overhaul could provide people with a broader choice of insurance options. The rules, they say, could be especially unfair to some lower-income workers who are enrolled in costly job-based insurance. Also, they argue, the restrictions would hurt the proposed public plan by limiting enrollment.

Jonathan Oberlander, associate professor at the University of North Carolina at Chapel Hill, said the restrictions create a "big gap between the rhetoric and the reality" of health reform.

"The rhetoric is that Americans will gain new alternatives," he said. "But the reality is that they are putting up firewalls that are going to restrict the access of people with employer-sponsored insurance to the exchange."

One result, he said, is that any public plan would be substantially smaller than what many backers are envisioning. That would reduce the public plan's power to compete with private insurers and hold down costs, he said. The Congressional Budget Office estimates that nine million to 10 million people would enroll in the public plan by 2019.

James Capretta, a fellow at the Ethics and Public Policy Center, a conservative think tank, said that the government is "essentially telling people you have to take your employer-based plan...I think that's a huge issue."

Most individuals would have to carry insurance or pay a fine, under the congressional proposals.

Much of the debate is driven by cost, and by efforts by lawmakers to keep the legislation's tab at about $1 trillion over a decade. Under the proposals before Congress, people who could go on the exchange include the uninsured, the self-employed and those who aren't offered employer-sponsored coverage. Small businesses also would be allowed to use the exchange to buy coverage for their workers.

The vast majority of the people on the exchange would get subsidies, at an average amount of $6,000 a year in 2019, according to a CBO analysis of the House plan.

Limiting the number of people who could use the exchanges, therefore, would hold down the cost of the legislation because fewer people would get government subsidies.

At a July 1 "town hall" meeting on health care, Obama said any health care overhaul must "fix what's broken about the system and that means permanently bringing down costs and giving more choice for everyone." He also played up the importance of creating a public plan that would compete with private plans.

The exchange, he said later in his remarks, would benefit small businesses and the self-employed, as well as workers at firms that do not provide coverage. "You may qualify for a subsidy from the federal government. And you then become part of a big pool that gives you some leverage over the drug companies and the insurance companies to drive down costs," he said.

Linda Douglass, communications director for the White House Office of Health Reform, said that the president "believes that health reform must be built upon our current employer-based system." The exchange, Douglass said, "is there to provide security and affordable options to Americans who don't have those options now."

To prod employers to continue to offer coverage, the bills would require most employers to provide insurance to workers or pay a penalty. In addition, employers would have to meet coverage standards and contribute to the cost of employees' insurance.

The Senate Health, Education, Labor and Pensions Committee bill would require employers to pay at least 60 percent of their workers' premiums, while the House proposal would require employers to cover 65 percent to 72.5 percent of the premiums. That means that job-based coverage is most likely to be the least expensive option for many people, especially those who don't qualify for government subsidies.

The measures also would set hurdles for people who want to transfer from their job-based coverage to health plans offered by the exchange, including any public plan.

Under the Senate health bill, individuals who are offered employer-sponsored coverage could switch to the exchange only if their share of the premiums exceeded 12.5 percent of their incomes or their job-based plans did not meet minimum coverage standards. That's similar to what the Finance Committee is considering.

Under the House Democrats' legislation, workers who are eligible for job-based insurance could go on the exchange only if their costs were more than 11 percent of their incomes. The CBO estimates that three million people would fall into that category by 2017. Both the House and Senate health committee bills would offer sliding scale subsidies for insurance on the exchange to those earning up to 400% of the federal poverty level, about $43,320 a year for an individual.

People willing to pay for their entire premiums, without subsidies, also could enroll through the exchange, under the House bill. There's no way to know exactly what the premiums would be, but the average cost for family coverage available through employers last year was $12,680, according to the nonpartisan Kaiser Family Foundation. The cost for covering individuals was $4,704. (Kaiser Health News is part of the foundation.)

Lawmakers and some health care analysts say that legislation has to create barriers around the exchange to protect the stability of the employer-provided insurance market. Without the restrictions, called firewalls, younger and healthier workers, they say, might find cheaper options on the exchange, leaving older and sicker workers in their employers' plans—and driving up their costs.

"We are trying to provide as much choice as possible and trying to honor the president's promise to protect the employer-based system so that if people have coverage they like they'll get to keep it," said Sen. Sheldon Whitehouse, D-R.I., a member of the health committee. "That's the way you resolve that balance."

To keep the pool of people covered by an insurance plan strong, "you just can't allow people to drop out of employer-sponsored coverage," said Paul Van De Water, a senior fellow with the liberal-leaning Center on Budget and Policy Priorities in Washington. "You don't want people to think they can get a better deal by just going into the exchange."

Jacob Hacker, a Yale University professor of political science, said the debate reflects "a delicate dance." On the one hand, lawmakers want to give people access to affordable coverage through the exchange. On the other, they want to protect the employer-based insurance system.

"To my mind," he added, the House bill "errs too far on the side of making it hard for

workers to obtain coverage through the exchange."

Richard Curtis, president of the Institute for Health Policy Solutions, a nonprofit research group, says some lower-income workers with employer-sponsored coverage could wind up paying a bigger chunk of their incomes for coverage than those with the same incomes who aren't offered job-based insurance. The reason: The latter group would be able to get subsidized coverage through the exchange.

That sends an unfortunate signal, he said, to people struggling to pay for employer-sponsored insurance. "So the message to them is, 'Congratulations...so now you get to continue paying several times as much as your next-door neighbor who has access to highly subsidized coverage in the exchange,'" he said. "On its face, it's just not fair."

In Massachusetts, which set up an exchange a few years ago as part of its health care overhaul, state officials put strict limits on who can participate. Workers with job-based coverage can't qualify for subsidized coverage, even if their work-based plan is considered unaffordable.

The result: some workers "are stuck with what their employer offers them," said Carol Pryor, policy director for the Access Project, a Boston-based nonprofit that works with local groups on health issues. "From the consumer perspective, it leaves a lot of people in a situation that's not financially affordable."

Richard Powers, spokesman for the Massachusetts Exchange , said that financial constraints have kept the state from offering subsidized coverage to workers with job-based insurance.

More than 600,000 Massachusetts residents earning under 300 percent of the federal poverty level, or $32,490 for an individual, currently get health insurance through their jobs, he said. "For the state to subsidize them...is economically unfeasible." Lower -income people who can't afford their job-based coverage are exempted from the state mandate that they carry insurance.

Some say that the important thing is expanding coverage, not providing additional choices to people who already have coverage.

Richard Kirsch, national campaign manager for the group "Health Care for America Now!," said that, ideally, a health care system would allow workers to choose to receive their health care coverage from their job or from the exchange.

"That's not the kind of change we're going to see so ...our focus is do consumers have protections," he said. "If you have [health insurance] at work are you protected and if you don't have it at work are you protected? That's for us what we're most concerned about."

Jaclyn Schiff contributed to this story.

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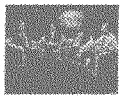
- 

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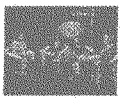
- 

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Senator WYDEN. A lot of the workers in this country who are being told they are going to get expanded choices, according to my analysis and Kaiser, are going to wake up and find they don't have that expanded array of choices.

Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Wyden.

Senator Whitehouse.

Senator WHITEHOUSE. Thank you. Just to followup for a moment on health care before I turn to another subject, George Bush's Treasury Secretary Paul O'Neill has written recently that there is $1 trillion a year of excess cost in our health care system, and he is no fool, is he?

Mr. ELMENDORF. No, I do not think he is. I only met him once, but I don't think so.

Senator WHITEHOUSE. And the President's Council of Economic Advisers has recently put out a report that suggests that there is $700 billion in excess or waste cost in our health insurance system. And they are credible, aren't they?

Mr. ELMENDORF. Yes, I think they are.

Senator WHITEHOUSE. So it appears that we have a very big savings target to shoot for in the health care system. You yourself have said in your letter to Chairman Conrad and Ranking Member Gregg that there are "large reductions" that are possible.

It strikes me that the problem here is that in order to achieve those large reductions, a considerable amount of executive management, of experimentation, of flexible and dynamic regulatory activity going forward is going to be necessary. There is not a light switch that you flip and this happens.

Mr. ELMENDORF. Yes, absolutely.

Senator WHITEHOUSE. Which means two things. One, it is very hard for you to score that because of that. I see a head actively nodding.

Mr. ELMENDORF. Yes, absolutely.

Senator WHITEHOUSE. And, two, it means that it is difficult for Congress to decree that it happens. We are in a better position to try to establish the parameters for that happening and then whip the executive branch as hard as we can to perform. But it actually will take executive administration and constant ongoing regulatory oversight to make the pursuit of those savings successful.

Am I correct in that?

Mr. ELMENDORF. Yes, I agree entirely.

Senator WHITEHOUSE. OK. Let me switch topics to cap-and-trade. A mental gear shift for you. You have estimated that the allowance purchases by corporations subject to now having to pay something for polluting the environment with carbon, that 25 percent of whatever they have to pay for is lost revenue to the Federal Government. And I understand that the 25 percent comes from an approximation that is a historic tradition within CBO based on your report on that.

What I am having trouble understanding is why—the money doesn't just go up into the Federal Government and disappear. As the legislation that we are looking at goes, it sprinkles back to utilities, it sprinkles back to green energy, it sprinkles back to conservation programs, it sprinkles back to investment in new industry.

Why is it that the expenditure on the allowance is subject to a 25-percent reduction, but there is a presumption that as it comes back into the economy, there is a zero tax consequence of all of that expenditure and investment? And, hypothetically, let us just as-

sume that it is the same amount, that is $1 out and $1 back; it is just reorganizing the economy so that there is a cost for carbon pollution, but that the Government pushes all that money back into the private sector. Hypothetically, wouldn't that wash?

Mr. ELMENDORF. People love talking about this 25-percent offset. It really is one of the more bedeviling topics.

Senator WHITEHOUSE. And we do not have time to get into the gory details. I am trying to focus in on the reverse. Why the zero——

Mr. ELMENDORF. The standard issue here is that if the Federal Government levies an excise tax of sorts on firms or individuals, the amount that they pay for that they can deduct from their income, and their taxable income or taxable profits are reduced as a result. And 25 percent is essentially the average marginal tax rate on income in——

Senator WHITEHOUSE. That is the part I understand. Why is it on the way back a zero?

Mr. ELMENDORF. It depends on how the money is given back to the private sector. There are ways to give it back that go back into the income stream that do not generate this offset or generate the phenomenon you are describing in which it all nets out. And there are other ways in which it does not, and it depends whether—I think the short answer is it depends on whether the money is given to taxable entities in a way that enters their income.

So if the allowance—if the money received by the Government were given to me in a way that I would then have to declare it on my 1040 Form, then I would end up having a higher income and paying tax on that. That would essentially offset the reduction in tax paid by whoever it was who was having to pay for the allowance.

So it matters who it goes to, but it has to go into the income stream——

Senator WHITEHOUSE. My time has run out, but just one very quick technical question. If it didn't appear on your 1040 but if in turn you spent it on wages for people, same difference, right?

Mr. ELMENDORF. Well, no. The challenge with the spending is that we also——

Senator WHITEHOUSE. Well, two other questions. I do not want to burden other people's time. If——

Mr. ELMENDORF. Can I have just 30 seconds with the Chairman's allowance? The other part of the constraint here is that we do our estimates of the effects of legislation, assuming that overall GDP is fixed. We do not do dynamic scoring in the sense of allowing the overall macroeconomic aggregates to change. So this money has to go back into the income stream. If it just is spent, then because GDP is fixed, that spending is essentially driving out some other aspect of spending in the economy.

That may not be sufficiently clear, and I am happy to continue the conversation.

Chairman CONRAD. Senator Nelson.

Senator NELSON. I want to followup the excellent line of questioning by the Chairman and Senator Wyden. Basically you said in response to the Chairman that in order to reduce the cost of Medicare over time so that the Federal Government can afford it, we

are basically going to have to do significant improvements, No. 1, in the efficiency of the delivery system; and, No. 2, you said we are going to have to stop the oversubsidization that we do now through the employee being exempt from taxation on his insurance premiums paid by his employer. Is that in essence what you said?

Mr. ELMENDORF. Yes. I just want to be careful about the word "should." The choices are yours, but we have outlined those as the key levers that you have.

Senator NELSON. OK. Now, this has gotten all balled up politically, but if we address that head on, now I want to go to Senator Wyden's question, and I want to understand this. If you stop the tax subsidy which is in current law of the employee's part of what they receive from their employer of health insurance premiums, and instead change that to where everybody has a tax deduction, that helps the employee. But how does that help stop the subsidy and, therefore, the financial problem over time to the U.S. Government?

Mr. ELMENDORF. I think it depends crucially on the structure of this deduction, and it depends crucially on what you are doing about payroll tax treatment as well. So under current law, the benefits employees receive from their employers for health care are not subject to either payroll tax or income tax. So there are different ways one could proceed. One could take away or limit the income tax exemption subject to an amount above some threshold, for example, to income taxes. One could also subject that amount to payroll taxes, although that issue has not been discussed as much of late. One could also structure this as a deduction of a fixed amount so that essentially any purchase of insurance above that amount would not get any additional deduction.

The crucial point here is the incentive on the margin for spending an extra dollar on health insurance. What changes behavior is making people pay essentially full price for an extra dollar of health insurance as they pay full price for an extra dollar of any other good they would consume rather than paying this tax-subsidized price.

Senator NELSON. Well, what would be the difference between-let's say that we took a certain amount of the exemption, let's say everything under $20,000 of equivalent income as applied to a health insurance premium, everyone under that for the employee was exempt, but above that, the employee was going to pay income tax on it. In other words, a Cadillac or a Mercedes policy that was very rich, they were going to have to pay income tax on it. What is the difference between that and doing it as a tax deduction saying that we are going to give a tax deduction worth $20,000 to every employee?

Mr. ELMENDORF. So if I understand the question right, those effects are the same for employees who are at the level of the deduction or higher, the level of capping the exemption or higher, but could affect employees below that differently. If there is a standard amount that everybody can deduct, that is going to have a different effect—then the question is: What if you buy the Kia insurance policy? What happens to the gap between that and the cap or the standard amount? And I think that is the part that people can treat differently, depending on how you structure—whether you

have an exemption or deduction, whether the deduction is specifically around how much you paid for insurance or some standard amount that everybody can deduct.

Senator NELSON. Mr. Chairman, one more question, if I may. If we said that everybody with a policy worth $20,000 per year is going to be exempt if they are an employee in an employee plan, and above $20,000 of premium per year they are going to pay income tax on, and if we try to get the escalating cost of medical cost in line with the annual cost of living, is that going to make a substantial difference in what the Federal Government is going to pay over the next 10, 20, 30 years?

Mr. ELMENDORF. Yes. I mean, certainly the first part by itself, if there is a cap on the amount that can be excluded from taxable income, that itself saves money. It saves more money over time if the cap rises more slowly than health costs. So it depends a lot on what the exemption is indexed to. If it is fixed in amount or indexed to overall inflation rather than health costs, then it will have increasing savings over time.

And I think in the second part, that will by itself create pressure that will reduce private health spending. On top of that, if there are other actions that are taken by the Government to bring its support for health through Medicare or Medicaid down, then that would have complementary effects in improving the Federal budget outlook.

Senator NELSON. Thank you, Mr. Chairman.

Chairman CONRAD. Thank you, Senator Nelson.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and I apologize on the front end that these questions may have been addressed, and as a new member, I am still trying to understand some of your methodology.

Mr. ELMENDORF. I am a new Director, Senator, so if I cannot help you, then my colleagues behind me will.

Senator WARNER. Well, having seen, at least secondhand, some of the scoring that has been done on some of the proposals around health care reform, particularly as regards prevention, wellness, system benefit design, that seem to be scored relatively low, yet seem—and I wonder whether how much kind of real-life examples are brought into that scoring process. Because one of the things, I think, that has been—as I have re-delved into this issue, that is a dynamic real change processes that corporate America, at least the more progressive companies, large employers, self-insured that have their own benefit design plans, there has really been a fairly radical change in the last just 3 to 5 years in companies that have really aggressively gone on cost containment.

Many of us here have talked to Steve Burd in terms of Safeway, but there is a host of other companies that have had similar actions, much of that based upon issues regarding—around prevention and wellness. Is that kind of real-life examples factored into your analysis in terms of scoring costs?

Mr. ELMENDORF. Yes, it is, Senator. We take the real-life examples very seriously, but I understand that our analysis of the effects of prevention and wellness initiatives is one thing that has made, I think, more Members of Congress more frustrated with us

than almost anything else. Let me spend just a few minutes explaining how we think about this and what the evidence shows.

Senator WARNER. Please.

Mr. ELMENDORF. Think of a simple medical test to start with, and then I will broaden the scope. That test will discover that some people have some condition that can then be treated in the early stage rather than waiting until it becomes more apparent later. For that person, doing this test early is good for their health and reduces their health spending, perhaps substantially.

The challenge is that there are a lot of other people given the same test who will come back negative, thankfully. Giving them the test has raised their health spending relative to what would otherwise have occurred, but not very much, presumably, per person relative to the savings for the people who end up having the disease caught early.

On the other hand, for most diseases there are many more people who don't have than do have it. So analyzing the effect on overall health pending of an extra test involves weighing the extra cost, the small extra cost for a large number of people who come back negative against the large savings for the smaller number of people who come back positive.

There are actually hundreds of studies that have done this for specific preventive measures, and as you would expect from this logic, preventive measures that are more targeted than others are more likely to be cost-saving. So all sorts of screenings that are cost-saving if done on a periodic basis for older people are moderately costly if done on a periodic basis for younger people, are very costly if done on a very high-frequency for younger people.

Senator WARNER. But can I—I mean, I think I understand this, and I do not mean to be rude, but I have got one other question I want to ask, and my time is running out. But I guess that is based upon procedural screenings. What I think has driven a lot of the actions that have come out of the private sector corporate plans have been incentives toward behavior modification, not in terms of identification of a disease.

Mr. ELMENDORF. So there are a few issues—and Safeway is a good example of this, and we have talked, in fact, with Steve Burd, and we have talked with actuaries and financial people at his company as one example of this.

Safeway has done a number of things. One is they renegotiated contracts with their health care providers. They bargained harder.

A second thing was that they gave the employees financial incentives to economize, first, on the use of health services, just the sort of cost sharing that I discussed with Senator Gregg a few minutes ago.

Third, they provided real financial incentives for more healthy behaviors.

Those are much more forceful policies and go well beyond wellness itself, and that collection of policies, if presented to us——

Senator WARNER. Would be——

Mr. ELMENDORF [continuing]. Would save money. But that is much more aggressive on the behavior side than many of the things that we see that are just more generally encouraging of good behavior. And then we need to try to assess how much any indi-

vidual program is actually going to alter behavior and what effects it will have.

Of course, some of these things will have larger effects outside the 10-year budget window, but we just do not do numbers too far out because it is too uncertain.

Senator WARNER. Mr. Chairman, could I ask one more question? I know my time has expired.

Chairman CONRAD. Yes, sir.

Senator WARNER. It is an issue that I think we have—that I had before you, and it is—let me preface it again by saying it is a challenging issue that has not only health care, political, financial, but also moral implications as well; that is, I have legislation pending about raising end-of-life issues, recognizing that 70 percent of Americans have no advance directives, have no living wills, other types of issues. And all the data as I have seen is that if we encourage the utilization of more palliative care, if we train people in the medical field to have these kinds of conversations with families earlier on, if we engage religious leaders as well to be willing to talk about these issues, and that there are real living examples that actually enhancing hospice-type services outside of the last 6 months when folks are still in the curative stage, to encourage these conversations, and by no means—let me make very clear here—no indication here of any effort to limit people's choices, limit people's care, limit all their options, but just make sure families have these options, that companies like United and Aetna and others who have enhanced, increased these services, that more people choose perhaps not to spend their waning days in the hospital, but choose other options.

We think and they have shown that increased patient satisfaction, increased family satisfaction, and, on average, cost savings north of $5,000 per person, you know, we are trying to work with your staff now on trying to get approaches like this scored and—because it seems to me that this is an area that, again, because it goes beyond the realm of politics. It is a deeply moral and religious issue as well. But encouraging these conversations, we found from the faith community a real willingness to engage on this issue, again, just laying out people's choices and encouraging them to have these conversations.

I would hope we could work with your staff on trying to—you know, this is a sensitive area, trying to have this area looked at, and, again, recognizing that there are real-life examples, models being used that demonstrate, as I mentioned, both increased patient and family satisfaction and cost savings. Have you all looked at this issue at all?

Mr. ELMENDORF. Senator, we have not looked sufficiently at this issue, and we recognize that that is a gap in our health care work and a gap that we are eager to fill when we have a chance to do that. And we are looking forward to working with you and your staff.

Senator WARNER. I have legislation—and it is before you—that we have been urging you to get some kind of scoring back, and I know you have got other things on your plate. But I will take that as a commitment that you will work with me directly on trying to get this——

Mr. ELMENDORF. Yes, we certainly will, Senator, and I will check on this when I get back to the office.

Senator WARNER. Thank you, Dr. Elmendorf.

Thank you, Mr. Chairman.

Senator WYDEN [presiding]. Dr. Elmendorf, thank you. Thanks for your patience. I understand you have got to be out the door at 10:30. I have some additional questions. I am sure my friend does as well.

When I asked earlier about premiums, we talked about the broken individual insurance market in terms of your answer, and certainly there is some benefit there.

But most of the people are in the employer market or in group health plans, and the reason I asked the question is my understanding, the way the House and HELP Committee bills are structured now, that if there is a judgment that these workers have affordable employer coverage, they wouldn't get access to the exchange in most cases. That is why I said I am struggling to try to find what most workers in this country who are in these group health plans are going to get in the next few years in terms of ways to hold down their premiums. And let's talk about those workers for a minute. Are they going to get anything in terms of premium reductions in the next few years?

Mr. ELMENDORF. We do not think those workers would see a noticeable change in their premiums. There are a variety of forces at work that can have small effects. There are Medicare reforms that can spill over to the private sector. There is the potential for more or less cost shifting from public plans to the private sector.

Our sense at the moment, based on our understanding of the specifications of the House proposal, is that those would not be significant effects, no.

Senator WYDEN. I appreciate your clearing that up, and I know my colleague from New Hampshire is concerned about this as well. These are people who in many instances are seeing double-digit premium hikes, and they are hearing across Washington that their premiums are going to go down. And you have just told us that in many, many cases that is not going to happen. So we have got a lot of heavy lifting left to do.

Let me ask you about the implications of not reforming the tax exclusion, certainly a way a number of us on this panel, a number of Senators on both sides of the aisle have cosponsored the approach that we talked about earlier. But let's say you don't go that route, and, in effect, Dr. Elmendorf has said there are two cost containment tools. One of them is changes in Medicare. The other is changes in the tax rules. So those are the two big sets of changes.

If you, in effect, only go with one of the policy levers, is it fair to say that there will be significantly less cost containment as a result of, in effect, putting aside one of the major tools?

Mr. ELMENDORF. Yes, Senator. One could do much more dramatic things, I suppose, on the Medicare side to offset that. But it is certainly a difficult challenge, and tying one of the two hands behind one's back makes the job much, much harder.

Senator WYDEN. Just a couple other questions. Most of the money in the legislation goes to expanding Medicaid, and I am very much committed to expanding coverage. I think Medicaid is a bro-

ken program. What I would like to see is poor people sitting next to their Congressperson in their doctor's waiting room, you know, so that there would be new dignity and fairness for poor people. We will see how that plays out.

But I am trying to think about how small business owners, in effect, from, you know, Coos Bay, Oregon, to Oyster Bay, New York, are going to benefit from the big chunk of spending in this legislation. What are the implications of setting up, you know, a significant new entitlement program? What are the implications for small businesses?

Mr. ELMENDORF. For businesses that are quite small, there are special subsidies in the House proposal to purchase health insurance that would benefit them. Small businesses that are small but above those thresholds could still benefit because if they are currently buying health insurance, they are doing it in this largely broken small-group market. If they are not currently buying insurance, then one problem they may have competing with larger employers for employees is that they don't offer health insurance, and those employees would have the opportunity to go into a health insurance exchange.

Senator WYDEN. I am talking about the implications of the additional entitlement spending. There is no question that there are some benefits for the small businesses in the exchanges. But in terms of setting up a new entitlement program, you know, what are the implications for small businesses? Because it seems to me absent the kind of cost containment reforms I would like to see, you set up a new entitlement program, small businesses get more taxes?

Mr. ELMENDORF. Well, I think the issue here is that setting up these insurance exchanges and providing subsidies for low-income people would disproportionately benefit small firms because they tend not to offer health insurance today or to pay larger amounts for it, and because they often employ a lot of low-wage workers. But you are absolutely right that there is this broader issue which is that money to provide subsidies for somebody comes from somewhere, somebody else, and to that extent, expanding entitlement creates an actual or potential future burden on somebody else who will have to foot the bill.

Senator WYDEN. One last question and just on this point, and I appreciate your answer. I am a passionate supporter of making sure that those who are uninsured get good-quality, affordable coverage. Senator Gregg and I are supporters of legislation that would ensure that justice is finally done for those folks.

What I am concerned about is, absent cost containment, if all you do is expand an entitlement program, as sure as the night follows the day, you are going to see taxes shifted onto these small business folks.

One other question with respect to the implications of the Medicare changes over the next few years. The theory behind the Medicare reforms that has the support of I think virtually every Senator I have talked to is that you can make transformative changes for the long term. You have suggested that in the budget documents, and I certainly agree with them.

The problem is, as you all have stated, that most of them are untested, and as a result, they are relatively modest savings in the short term.

So in the next budget window, the next 10 years, what are the implications of trying to find these significant savings in Medicare, the cuts and other savings, in order to pay for program expansions? What are the implications for Medicare?

Mr. ELMENDORF. Well, so, I agree with the premise of your question, of course, about the difficulty of choosing particular transformative changes that we can have confidence will work. There are other ways, of course, to save money in Medicare. MedPAC provides a regular list of suggestions—they work for you; unlike us, they make suggestions, recommend policies—a variety of ways they think are out there to adjust the payments that are made to providers that they think would be more in line with those providers' true costs.

There are also broader changes that one could make, for example, to increase provider payments over time in a way that takes the costs but also adjusts for presumption for rising productivity in the health area. And, again, some of the members of my panel of health advisers are very optimistic about the ability of the health care system with IT and with a renewed focus on cost efficiency to reap productivity gains; and if that is true, then one can raise the payment rates by smaller amounts to account for that, and they would still be whole.

As you know, it is a very large program, and there are a variety of ways one can make changes. But they are not costless in important ways. I mean, ultimately for the Federal Government to save money, it has to pay somebody else less. And if the people who are getting paid less can find a way to do what they have to do at lower cost, then that works out. If they can't, then there is a squeeze, and that is the problem that one encounters if one is simply sitting on provider payments without there being a sort of opportunity or a path by which providers can really reduce their costs.

Senator WYDEN. I am very hopeful about those productivity gains down the road. I just have been reading your reports, and I have not seen the likelihood that that is going to be generated in the next few years. And, again, the challenge will be for a Senator to explain to those on Medicare why these programs are going to have, you know, fewer dollars, and particularly why we are not going to see the productivity changes until much further down the road.

Senator Gregg.

Senator GREGG. Mr. Director, your testimony has been sobering today, because essentially what you have said is that an item which the administration appears to be taking off the table is essential to getting health care costs under control, which is the deductibility of insurance.

The present plans as they have been produced have no significant cost-bending events in them relative to reimbursement and relative to the way that they structure health care; most Americans' premiums are not going to go down, and they will continue to go up; and that the debt of this country is unsustainable on our

present course, and there is not a whole lot in this health care debate to date relative to the bills that have been produced that is going to do anything but continue to aggravate that and actually expand that problem.

That is my summary of what you have said. Is that a reasonable summary?

Mr. ELMENDORF. The only point I would be careful about myself is I don't know what the administration is or is not taking off the table.

Senator GREGG. I understand. I hope they haven't taken it off the table.

Mr. ELMENDORF. But on the summary of a sobering perspective, yes, I agree with that, Senator. I am sobered by having to give it.

Senator GREGG. So shouldn't we step back, because we are clearly not pursuing the path we desire to be on, which is to get all Americans covered by insurance, but do it in a way that actually makes our—doesn't aggravate our potential insolvency as a Nation? Shouldn't we step back and take another look at how we are going to approach this thing and address the issues which you have given us a very clear outline today we need to address—which have been highlighted by Senator Wyden and Senator Conrad and Senator Warner and Senator Nelson. Because we seem to be hell-bent for leather on passing something that is not going to get where we need to go relative to either making insurance available or containing its costs relative to the effects it is going to have on future generations and the solvency of our Nation. That is a rhetorical point.

Thank you very much for your time.

Mr. ELMENDORF. Thank you, Senator.

Senator WYDEN. Dr. Elmendorf, thank you for being so responsive to this Committee, and also because I serve on the Finance Committee, I know that you have been putting many, many hours and sometimes I suspect that you and your staff are being fed intravenously because we have you at your desk incredible hours, and we thank you for your help.

Mr. ELMENDORF. Thank you, Senator.

Senator WYDEN. The Committee is adjourned.

[Whereupon, at 10:16 a.m., the Committee was adjourned.]

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Douglas W. Elmendorf, Director

September 10, 2009

Honorable Michael B. Enzi
Ranking Member
Committee on Health, Education,
Labor, and Pensions
United States Senate
Washington, DC 20510

Dear Senator:

This letter responds to several questions that you raised following my appearance before the Committee on Health, Education, Labor, and Pensions (HELP) during its consideration of the Affordable Health Choices Act. The Congressional Budget Office (CBO) and the staff of the Joint Committee on Taxation (JCT) issued a preliminary and partial analysis of that legislation as it was introduced on July 1, 2009.[1] We have not completed an assessment of the legislation as it was ultimately approved by the committee, including the amendments that were adopted during markup of the bill.

Effects of Expanding the Medicaid Program

You asked what the total cost would be of combining the committee's legislation with an expansion of eligibility for Medicaid for all legal U.S. residents with income below 150 percent of the federal poverty level (FPL). As you know, the Affordable Health Choices Act, as introduced, would not expand eligibility for Medicaid, but an earlier draft included language indicating that such an expansion would be added by the Senate Finance Committee (which has jurisdiction over Medicaid). Because our analysis of the introduced legislation examined only the changes in law that would result from it, we could not presume an expansion of eligibility for Medicaid or other new subsidies for health insurance beyond those that were specified. Overall, our preliminary assessment was that the provisions of the legislation pertaining to insurance coverage (contained in title I of the

[1] Congressional Budget Office, letter to the Honorable Edward M. Kennedy providing CBO's preliminary analysis of title I of the Affordable Health Choices Act (July 2, 2009).

bill) would increase federal deficits by $645 billion over the 2010–2019 period.

As CBO indicated in its letter to Senator Gregg on July 6, 2009, expanding eligibility for Medicaid to legal residents with income up to 150 percent of the FPL would increase the federal cost of the legislation considerably—by an amount that is probably on the order of $500 billion over 10 years.[2] (CBO did not estimate the costs to state governments of such a Medicaid expansion, but those costs would probably be relatively small because the options that CBO examined to expand Medicaid would have required states to cover a much smaller share of total spending than is seen in the current Medicaid program.) Therefore, the 10-year cost of the coverage expansion to the federal government, including such a change in Medicaid eligibility, would probably exceed $1 trillion. Combining such an expansion with the Affordable Health Choices Act as introduced would also yield a substantially larger reduction in the number of people who are uninsured than would arise from the act alone, because about half of the people projected to be uninsured under current law would have income below 150 percent of the FPL.

Because the magnitude of the effects on both federal costs and rates of insurance coverage for the combination of the committee's legislation and a Medicaid expansion would depend importantly on the details of the proposal, we cannot give you a more precise estimate at this time. For example, the effects would depend on how eligibility for Medicaid was determined and on whether the expansion started in 2010 or at a later date. The effects would also depend on what share of the costs for newly eligible people was borne by the federal government and what share was borne by the states. Furthermore, the effects would depend on whether states faced a maintenance-of-effort requirement relative to their current Medicaid programs. Regardless of its specific features, adding a Medicaid expansion to the introduced bill would not only affect federal costs for Medicaid but also have implications for other components of our preliminary estimate—because employers and individuals would probably respond to the bill's other provisions differently in that case.

An illustration of the effects of including a substantial expansion of Medicaid can be seen in the preliminary analysis that CBO and JCT have provided of the coverage specifications reflected in H.R. 3200, the

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[2] Congressional Budget Office, letter to the Honorable Judd Gregg regarding the likely effects of substantially expanding eligibility for Medicaid (July 8, 2009).

America's Affordable Health Choices Act of 2009, as introduced in the House of Representatives on July 14, 2009.[3] That proposal would expand eligibility for Medicaid to all nonelderly individuals with income below 133 percent of the FPL (with all of the costs for newly eligible enrollees borne by the federal government) and would provide subsidies via insurance exchanges on a sliding scale for those with income up to 400 percent of the FPL. CBO estimated that federal outlays for Medicaid would increase by $438 billion over the 2010–2019 period because of that expansion of eligibility for the program and related measures. That figure includes the estimated costs of a proposed increase in Medicaid's payment rates for primary care physicians, but does not include the costs of providing subsidies for insurance to people with income between 133 percent and 150 percent of the FPL (which have not been separately estimated).

Effects on Employers and Employees

You also asked whether the costs borne by employers as a result of the proposal would be passed on to workers in the form of lower wages than they would otherwise be paid, and about the effects of the proposal on employment-based health insurance. Under the legislation as introduced, firms with more than 25 workers would have to offer health insurance (and contribute a specified share of the premiums) or pay a penalty. In general, CBO believes that firms that are subject to the penalty but opt not to offer health insurance would pass that cost on to their workers, primarily in the form of lower wages—just as firms that offer insurance today and contribute toward the premiums pay lower wages than they otherwise would, keeping their total compensation costs about the same. One exception would be workers earning close to the minimum wage, because their wages might not be able to adjust downward to offset the cost of the penalty; as a result, employment of those workers might be adversely affected, though that impact is likely to be small.[4]

As for the effects of the legislation on employment-based health insurance, CBO and JCT estimated that the version that was introduced on July 1 would not have a major effect on the aggregate number of people obtaining coverage through an employer; we estimated that in 2016, for example, the total number of people covered by an employment-based plan would be

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[3] Congressional Budget Office, letter to the Honorable Charles B. Rangel providing a preliminary analysis of the America's Affordable Health Choices Act of 2009 (July 17, 2009).

[4] For additional discussion, see Congressional Budget Office, *Effects of Changes to the Health Insurance System on Labor Markets,* Issue Brief (July 13, 2009).

about 163 million, or about 1 million more than is projected under current law.

That net figure reflects changes going in both directions. Some people would gain employment-based coverage, because the mandate to obtain health insurance would induce some employers to make an offer of such coverage that would not have been made otherwise or would induce some individuals to take advantage of an existing offer that they would not have accepted otherwise. At the same time, we estimated that about 6 million people who would have employment-based coverage under current law would not have such coverage under the proposal. That figure includes about 2 million workers (and their dependents) who would have an offer from their employer that would be deemed "unaffordable" under the proposal, thus allowing them to purchase subsidized coverage through the new insurance exchanges. It also includes about 4 million people who would have coverage through an employer under current law but would not have such an offer under the proposal. To what extent those changes in coverage would represent the dropping of existing coverage or expected offers of coverage that would fail to materialize is difficult to determine.

Effects of a "Public Plan"

You also asked whether the federally administered "public plan" that would be offered under the legislation as introduced would have a substantial effect on federal spending for health care. Under that proposal, the public plan would be managed by the Department of Health and Human Services, would pay negotiated rates to providers of health care, and would have to be financially self-sufficient (albeit with the government bearing some risk, as discussed below). Given those provisions, CBO's assessment is that premiums for the public plan would typically be roughly comparable to the average premiums of private plans offered in the insurance exchanges—and thus the existence of such a plan would not directly affect the amount of federal subsidies for health insurance under the legislation.

Nevertheless, including a public plan would probably have two small effects on the premiums of the private plans against which it is competing, both of which would tend to lower federal subsidy payments through the exchanges to some degree—but we have not quantified that effect by comparing the legislation as introduced to a proposal that was identical in all other respects but did not include a public plan.

- First, a public plan as structured in the introduced bill would probably attract a substantial minority of enrollees (in part because it

Effects on Overall Expenditures for Health Care
You also asked what effect the introduced legislation would have on national spending on health care. By itself, a substantial expansion of insurance coverage could cause an increase of between 2 percent and 5 percent in national spending on health care, largely because insured people generally receive somewhat more medical care than do uninsured people—notwithstanding the fact that some newly insured people would avoid expensive treatments by getting care sooner, before their illness progressed.[6] However, the rise in national spending on health care would be less than the increase for the federal government because some costs that are now paid by others would be shifted to the government (via the subsidies provided by the bill). Expanding insurance coverage would make it modestly easier to achieve certain types of reductions in national and federal spending on health care; for example, some governmental payments to hospitals that treat a disproportionate share of poor and uninsured patients might be trimmed accordingly.

More broadly, legislation could seek to offset the impact of an insurance expansion—on both federal costs and total spending for health care—by including other provisions affecting either the major federal programs that finance health care or the private insurance system. The bill as introduced would encourage private insurers to adopt measures to improve the coordination of the care they provide, but private insurers would be inclined to adopt cost-reducing strategies even in the absence of new legislation, so the effect of those provisions on costs is not clear. The insurance market reforms included in the bill would reduce administrative costs for individually purchased policies, but the resulting savings would probably be small relative to the increase in spending brought about by the insurance expansion. Given its overall scope, the bill would probably increase national spending on health care modestly.

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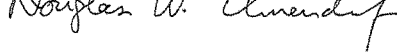
[6] For additional discussion, see Congressional Budget Office, *Key Issues in Analyzing Major Health Insurance Proposals* (December 2008), pp. 71–76.

I hope this information is helpful to you. If you have any questions, please contact me or CBO's primary staff contacts for this analysis, Philip Ellis (who can be reached at 226-2666) and Holly Harvey (who can be reached at 226-2800).

Sincerely,



Douglas W. Elmendorf
Director

cc: Honorable Tom Harkin
Chairman

Honorable Christopher J. Dodd

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