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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

- **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.