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PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

MARCH 4, 2009

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CONTENTS

OPENING STATEMENTS

WITNESS

ALPHABETICAL LISTING AND APPENDIX MATERIAL

PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL

WEDNESDAY, MARCH 4, 2009

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:07 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Rockefeller, Bingaman, Lincoln, Wyden, Schumer, Stabenow, Cantwell, Nelson, Menendez, Carper, Grassley, Hatch, Snowe, Bunning, Crapo, Roberts, Ensign, Enzi, and Cornyn.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; Alan Cohen, Senior Budget Analyst; Cathy Koch, Chief Tax Counsel; Tiffany Smith, Tax Counsel; Tom Klouda, Professional Staff Member, Social Security; and Pat Bousliman, Natural Resources Advisor. Republican Staff: Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; and Jim Lyons, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

The book of Deuteronomy commands, "You must have completely honest weights and completely honest measures if you are to endure long in the land the Lord your God has given you."

This is a very good budget because it is an honest budget. The budget is honest about the cost of the wars in Iraq and Afghanistan in all of the 10 years that it covers. The budget is honest about the cost of fixing the Alternative Minimum Tax in all 10 years. The budget is honest about the need for health care reform. As President Obama told Congress last week, health care reform cannot wait, it must not wait, and it will not wait another year. This budget makes good on that promise.

The budget is honest about the growth rates for discretionary spending in all 10 years. The budget is honest about providing estimates for 10 years, not just 5. The budget is honest about providing a placeholder for additional funds that might be needed this year for financial stabilization, and the budget is honest about the need for revenues to fund the government.

Now, just because this is an honest budget does not mean that this is an easy budget. The budget presents some difficult realities, and it presents some hard choices, but the budget is fiscally responsible.

For the first several years of this budget, the economy will be in a recession. During a recession, revenues fall. During a recession, spending on Unemployment Insurance, Medicaid, and other means-tested benefits automatically increases. To spur the economy, we enacted a powerful fiscal stimulus program. All these things cause the deficit to increase.

But most economists agree that during a recession, running deficits is the right thing to do. The decreased revenues and increased spending help to lessen the harm of the recession. Almost all of the effect of these measures on the deficit goes away once the recession is over.

The honest measure of whether a budget is fiscally responsible is not the size of the deficit during a recession. The honest measure is the size of the deficit once the recession is over. The honest measure of whether the deficit is high is the size of the deficit relative to the size of the economy.

On that basis, once the recession is over, the deficits projected in this budget are fiscally responsible. By fiscal year 2013, the deficit is projected to be 3 percent of the economy, and it remains at this level throughout the remaining years of the budget.

Why is this a responsible level? Because debt held by the public will remain stable as a share of the economy. Debt held by the public is projected to be about 66 percent in 2013, and it will be about the same in 2019. Keeping the debt held by the public stable is fiscally responsible.

And this budget is responsible because it addresses the most important challenge to our fiscal future: the growth in health care spending. Our number-one objective this year is to enact comprehensive health care reform. We need health care reform that provides coverage to all Americans, improves the quality of health care delivered, and contains the growth of health care spending. This budget provides a down-payment for health reform. The budget includes explicit policy proposals whose proceeds will go into this fund. In the coming months, this committee will explore these proposals.

We will also need to look at other ways to make the health care system more efficient. This includes examining the enormous role that taxes play in promoting health care. Currently, the law does not include the value of employer-subsidized insurance in employees' taxable income, and there are numerous deductions from income for people who save for health costs, contribute toward employer-provided health care plans, and incur out-of-pocket medical expenses.

These exceptions are projected to reduce income tax receipts by more than $200 billion in 2009, and that amount is projected to grow every year thereafter. Thus, one of the first places to begin tax reform is with health care reform.

I am also glad to see that the budget would help lower- and middle-income American families. The budget makes permanent many of the tax cuts enacted in 2001 and 2003. These include lower tax rates, marriage penalty relief, and expansions to the child tax credit, adoption credit, and childcare credits.

The budget also makes permanent the zero-percent and 15-percent capital gains rates for low- and middle-income taxpayers.

To help family businesses and farms, the budget can provide certainty under the estate tax, setting the exemption and tax rate at 2009 levels.

The budget also makes permanent several provisions enacted as part of the Economic Recovery bill. The Making Work Pay Credit will allow working Americans to take more of their hard-earned money home. The American Opportunity Tax Credit will help students pay for college, and families with children will get assistance from the expansion of the Earned Income Tax Credit and the Refundable Child Tax Credit. And the budget promotes savings for families by expanding the Saver's Credit and making it refundable, and by providing for automatic 401(k) and IRA enrollment.

The budget provides tax cuts for businesses as well. The President's budget also proposes several provisions that would raise revenue, and the committee will explore them this year.

I am pleased to see that the President's budget includes a proposal to codify the Economic Substance Doctrine. That is something that Senator Grassley and I have been trying to do for years. It is an important tool in cutting back abusive tax transactions.

Mr. Secretary, I know that you are focused on offshore tax evasion because of the international revenue proposals in the budget. Any background that you could give us today on these proposals would be welcome, and I look forward to working with you on legislation to recover the tens of billions of tax revenue dollars hidden overseas.

I am pleased to see that this budget includes funds for additional efforts by the IRS for reducing the tax gap. Every year, more than $345 billion of Federal tax revenue is owed, but is uncollected. Each additional dollar spent wisely on enforcement returns $5 to the Treasury. The budget includes $7.2 billion for a multi-year enforcement effort by the IRS.

Along the same lines, I am pleased to see proposals in the budget that provide for reducing fraud in health care, Social Security Disability payments, and Unemployment Insurance payments.

And, Mr. Secretary, we will also have questions for you today beyond the budget. Stabilizing our financial system is one of the greatest public policy challenges facing the government. I hope today that you can give us an update on capital injections into banks, aid to the auto industry, AIG, Citigroup, and the mortgage foreclosure relief program.

And I would like to also hear about any plans you may have to ask for an additional $750 billion for financial stabilization included in the budget on a contingent basis.

So I commend the President and you, Mr. Secretary, on the honesty of the budget. I commend you for taking on the tough challenges of the work ahead of us, and I look forward to rolling up our sleeves and getting that work done.

Senator Grassley is not here. I know he will be joining us shortly.

So, Mr. Geithner, why don't you proceed to your statement? As you know, your full statement will be automatically included in the record.

STATEMENT OF TIMOTHY F. GEITHNER, SECRETARY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary GEITHNER. Chairman Baucus, members of the committee, it is an honor to appear before you today to talk about the President's budget and the administration's economic agenda.

I want to just summarize the main points in my testimony, and I look forward to answering your questions.

We start this administration, this Congress, with a deepening recession, an intensifying housing crisis, and a financial system under stress. Since the recession began, 3.6 million Americans have lost their jobs, millions more have lost or are at risk of losing their homes, are struggling to obtain loans for cars, for higher education, and many businesses are finding it harder to get credit.

This crisis has helped cause a dramatic deterioration in our fiscal position. We start with a $1.3-trillion deficit, the largest as a share of GDP the Nation has faced since the second world war.

As a Nation today, we face extraordinary challenges, and these challenges require extraordinary actions. In passing the American Recovery and Reinvestment Act, the administration and the Congress have put in place a very powerful mix of programs to get Americans back to work and to stimulate private investment.

The combined effect of these investments and tax measures will be to save or create between 3 and 4 million jobs, and to increase real GDP by 3.2 percentage points by the end of 2010 relative to what would have occurred in the absence of that program.

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 the purchase of a home, or a car, or to meet their basic needs.

The deepening recession is putting greater pressure on banks, and in response, many banks are pulling back on credit. So right now, critical parts of our financial system are working against recovery. This is a very dangerous dynamic, and to arrest it we need to make sure that our banks have the resources necessary to provide credit to the economy, and we need to act directly to get the credit markets working again.

The President has also launched a broad plan to help address the housing crisis. This plan will help homeowners meet their mortgage obligations and enable them to refinance to take advantage of lower interest rates. Just this morning, we took the important step of releasing the details of our loan modification plan and Treasury guidelines for servicers, and this will help struggling borrowers begin to see lower payments, more affordable payments, right away.

These actions in all three areas are essential to lay the foundation for recovery. The President's budget builds on this foundation to set us on the path to higher long-term growth rates.

The first step, Mr. Chairman, as you said, in addressing our Nation's fiscal problems is to be honest about them. This budget breaks from the past by honestly and transparently presenting the fiscal challenges our country faces. We include the cost of fixing the AMT each year, reimbursements to Medicare physicians, the likely costs of future foreign wars and natural disasters, and the potential need, in an abundance of caution, for additional financial crisis funding. We offer a 10-year, rather than a 5-year, budget presentation.

This budget proposes to address the most critical challenges our economy faces in health care, in energy, and in education, within a framework that puts us on a path to fiscal responsibility and to fiscal sustainability.

As you know, the soaring cost of health care is crippling families, businesses, and our long-term budget prospects. There is no path to addressing our long-term entitlement challenges that does not require major health care reform. Our budget begins this process by reducing costs and inefficiencies, increasing quality and prevention, and moving towards more affordable coverage for all Americans.

Just to cite one example, the Hospital Quality Improvement Program in the budget proposes to pay for performance and reimburse hospitals for the quality of services they provide rather than merely the quantity of the services they provide. Health care reform is a moral imperative, it is an economic imperative, and it is a fiscal imperative.

Our budget also puts forth a significant commitment to reduce our dependence on foreign oil, a dependence that threatens our economy, our environment, and our National security interests. Investments in energy efficiency and renewal of energy will help create new American jobs and industries and lead the way to a new, green economy.

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 our country the quality education they need to compete in the 21st-century global economy.

Our 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.

On the tax side, the budget rewards work and encourages savings and investment that will spur growth. The budget proposes to make permanent the Making Work Pay Tax Credit for 95 percent of working Americans, and to expand the Earned Income Tax Credit. It also includes a zero capital gains tax provision for small businesses and a permanent extension of the R&E tax credit.

The budget proposes to address the tax gap by tackling tax shelters and other efforts to abuse our tax laws, and over the next few months the President will propose a series of detailed legislative proposals and enforcement measures to help reduce tax avoidance.

I want to emphasize that we propose no new revenue increases in our budget, none, until we are safely into recovery in 2011. At that point when the consensus of private forecasters projects significantly positive growth rates for the overall economy, the budget restores tax rates to the pre-2001 level for families making more than a quarter of a million dollars a year.

Even with the critical long-term investments in our economy proposed in the budget, the President's budget keeps, overall, non-defense discretionary spending well below its long-term average as a share of the economy. Overall outlays return to historical norms once you account for the interest costs associated with our inherited deficits and the impact of the baby boom retirement and rising health care costs on entitlement programs.

The President and I share a commitment to working with the Finance Committee and with the Congress to put our Nation back on the path of fiscal sustainability once recovery has been firmly established. The President's budget does this by making tough choices to cut the deficit in half in 4 years, and to reduce deficits to the level that is necessary so that overall debt is not rising, no longer growing as a share of the economy. If we do not do this, then we face the risk that government borrowing will, over time, crowd out private borrowing, resulting in higher interest costs and weaker growth.

When I last served in the Treasury Department in the 1990s, fiscal responsibility helped create a virtuous circle of greater confidence, strong private investment, strong productivity growth, and higher overall gains in income, more broadly shared across the American economy.

Now, addressing these problems, these challenges that confront our country, will not be easy, but we are a strong and resilient country. We have overcome challenges—extraordinary challenges—in the past and we will do so in the future if we work together, the administration and the Congress, in putting forth effective proposals to address these challenges.

Thank you. I would be happy to answer any questions.

The CHAIRMAN. Thank you, Mr. Secretary.

[The prepared statement of Secretary Geithner appears in the appendix.]

The CHAIRMAN. I now turn to Senator Grassley for any opening statement he might have.

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. I would apologize to the Secretary, because I was speaking on the floor of the Senate.

There seems to be a common refrain on the Democratic side that those on the Republican side cannot somehow, and should not, criticize the future record deficits and debt that the President's budget will produce. The premise of that position is that the last administration produced similar deficits. Moreover, the common refrain goes that the current administration, and implicitly the Democratic leadership in Congress, had no hand in creating the current fiscal situation.

Now, it is very true that President Obama inherited a big deficit, and not a deficit that we can be proud of. We on this side do not dispute that. But to say that it was bequeathed solely by those on our side, I think is misleading. I have a chart that will demonstrate that here. This chart shows the relative level of deficits over the past 8 years. The chart shows the effect of the economy that the last administration inherited: the flat investment pattern of 2000, the tech bubble bursting in 2001, the corporate scandals of 2001 and the economic shock of terrorist attacks on 9/11. These all occurred at the start of the last administration. They contributed to the sharp downturn in the fiscal situation that you see demonstrated there those years.

When the bipartisan tax relief kicked in, the deficits came down, you will see, in the period of 2004 to 2007. In 2007, we entered a period of divided government, Democratic control of the Congress. Unless I am missing something, all of the fiscal policy in the period of 2007 and 2008 was the product of a Democratic Congress and a Republican President. A Democratic Congress made policy bequests, and resulting deficit and debt, to President Obama, and a Republican administration joined in that bequest.

So President Obama inherited the deficit and debt, and of course it is very, very large, as you can see there with the last column. But that bequest was bipartisan. Mr. Secretary, as head of the New York branch of the Federal Reserve, you were a very key player in creating the Troubled Asset Relief Program, and a good chunk of the big deficit and debt is attributable to that policy.

I point this out to set the record straight so that we can constructively—with emphasis upon "constructively"—tackle the large fiscal problems we face, together.

Now I turn to today's hearing. A little over 4 years ago at this same annual hearing, I criticized the last administration in one important respect: for the lack of transparency in its budget. The criticism arose from the administration's—the Bush administration's—failure to include an extension of the Alternative Minimum Tax patch in its budget. It was towards the end of that hearing, and Senator Wyden brought this up, waiting his turn, in the final round of questions.

That exchange with Secretary John Snow led to a bipartisan effort to repeal the AMT. In 2007, when control of the Congress shifted to my friends on the other side, I likewise criticized them for not including an un-offset AMT patch in their budget. In addition, I pressed them to include extensions of popular tax relief provisions this committee developed in 2001 and 2003.

Both the last administration and the leadership on the other side adjusted their budgets to account for AMT relief and to deal with the broad-based expiring tax provisions. In neither case was all of the tax relief fully accounted for. In neither case was the revenue side of the budget fully transparent. President Obama's budget breaks new ground in terms of transparency. That is, of course, a very good thing. The budget reflects extension of the AMT patch, although it needs to be fixed to fully hold middle-income families harmless.

President Obama's budget, like the Republican administration's and congressional budgets, includes extension of the bipartisan tax relief packages of 2001 and 2003. Unlike these budgets, however, this budget repeals the tax relief for major categories of taxpayers. On principle, President Obama's budget agrees with the basic point many of us on this side have been making for several years, that is, failure to extend current tax law relief is a tax increase.

Getting that discussion on this level, which focuses on the merits of existing tax policy, is an improvement in the debate. For far too long—2 years, to be exact—we operated in an environment where the fiscal effects of extending current-law tax policy and spending policy were subject to entirely different levels of scrutiny. Expiring entitlement provisions and spending were not accounted for, increases in appropriation spending over the baseline were not accounted for, but every dollar of current-law tax relief was treated as the sole cause of deficits. Common sense would tell you that, for budget purposes, a dollar increase in spending should be treated the same way as a dollar of tax relief.

So I want to thank my President, President Obama, for bringing more transparency to the revenue baseline. It will enable those of us on Capitol Hill to more accurately discuss the tax policy changes as policy changes.

Turning to those changes, there is good news. I am pleased that the President recognizes the importance of some economic growth incentives. Last year, many on our side applauded President Obama's proposal for a zero capital gains rate for small businesses and start-up ventures.

For reasons I do not understand, the Democratic leadership resisted the proposal, even though Senators Kerry and Snowe introduced it in a bipartisan bill. Why, in a $787-billion bill, we could not err on the side of an aggressive capital formation incentive is beyond me. President Obama planted the flag for this incentive once again. He will continue to get my support and the support on our side for his doing that.

I mentioned the good news on the AMT patch. I am pleased that much of 2001 and 2003 tax relief is made permanent in the budget. The first bit of bad news is that those bipartisan packages are not extended in full. These are bad signals to send to workers, small business owners, and investors. I have to wonder if these signals might have something to do with a further downturn in the economy.

The second bit of bad news is that there is a new hidden marginal rate increase embedded in the budget. It is a proposal to place a ceiling of 28 percent on deductions for mortgage interest, charities, and State and local taxes. Let us review the bidding on the top two rates. The budget returns to the Clinton-era 36-percent and 39.6-percent tax brackets. In addition, the hidden marginal tax rate hikes known as PEP and Pease return. This is where we need more transparency by not reinstating PEP and Pease, but being more honest and having a 42- or 43-percent top marginal tax rate, if that is where you really want to go. These marginal rate hikes are particularly punitive to small business.

I would ask the Secretary to pay attention, because yesterday I heard what he said on television, that only 10 percent of the small business people would be hit. I want him to know that over half of the owners of small businesses employ between 20 and 500 employees, and are owned and operated by taxpayers that are targeted for these heavy marginal tax rates. I do not understand why you would charge small business operators more than you would charge corporations, but that is the effect of this.

In other words, I want to emphasize for the Secretary, over half are between 20 and 500 employees. Small business employs over half of the private sector workers in America; two-thirds of the small business workers are employed by firms employing between 20 and 500 employees. Those larger small businesses are also businesses most likely to expand or contract, depending on business conditions.

I would like to have you check the latest Small Business Administration data. It will tell you that small business created all the new jobs in this country in 2004. For 2007, the latest year for which data is available, small business created 74 percent of the new jobs.

A materially higher tax rate will, whether the other side wants to admit it or not, affect the ability of those businesses to expand and create jobs because it reduces after-tax cash flow. It reduces the after-tax rate of return from business activity. Expansion means more workers, contraction obviously means fewer workers.

So I would challenge anybody to tell me how raising the 33-percent bracket for small business to as high as 40 percent will positively affect that small business. I would challenge anyone to tell me how raising the 35-percent bracket for small businesses to as high as 42 percent will positively affect that business.

Mr. Secretary, I believe the President, and all of us, want to grow private sector jobs, so it is hard to see how this dramatic tax increase, which zeroes in on dynamic job-creating small businesses, will grow the private sector job base. In fact, private sector job loss seems more likely.

Mr. Chairman, last year we had a very informative hearing on the financial effects of the cap-and-trade tax. Then-Congressional Budget Office Director, Mr. Orszag, testified that cap-and-trade proposals are that: taxes. The budget reflects that view in how the cap-and-trade proposal is treated. We need to take a very close look at this proposal, particularly the tax burden it would place on American consumers, workers, and businesses. Furthermore, we need to know the actual amount of revenue the administration expects to raise under these proposals. The President's budget has it at $646 million, but it might raise a lot more than that.

Finally, there is a heavy business tax in this budget. We need to have a dialogue about those proposals. I am proud of all the Finance Committee loophole-closing proposals that Chairman Baucus and I have developed since 2001, some $200 billion in all, bringing in money that would not otherwise be there. But we need to be careful to separate loophole closures from generic tax increases on business.

One proposal in this budget dealing with treatment of overseas business income could put American companies at a competitive disadvantage. Tax increases that ultimately result in American companies shedding American jobs are not the right way to go.

We have an even bigger fiscal crisis coming. The baby boom generation will be retiring in big numbers in the next decade, and that is an entitlement problem. It is not derived from the current or future state of the Federal revenue base. Under this budget, the revenue base is set at above the historic average as a percentage of the economy. Unless the predilections of particular members are to solve the entitlement problem solely with record levels of Federal taxation, we need to deal with runaway entitlement spending. I do not see the 800-pound fiscal gorilla dealt with in this budget.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Mr. Secretary, I want to begin by just complimenting the President for focusing so much on health care reform. The President, Director Elmendorf, and Director Peter Orszag at OMB, have all said basically the path to economic recovery is through health care reform. That is clear, because health care costs are rising at such a rapid, rapid rate in America today, affecting, as you said, not only individuals who pay enormously high health care costs in America through higher premiums or higher co-pays or out-of-pocket, but also businesses because of the huge cost of doing business in America, compared with the health care cost of doing business in other countries, and third, the fiscal hit that State budgets, and certainly the Federal budget, are taking. I commend you for including a down-payment on health care reform.

My concern, frankly, though, is the viability of that down-payment and how the budget and how the administration will help Congress get health care reform enacted, and certainly cost containment and budget questions are front and center. The $634 billion in the budget is basically split: half of that is proposed cuts on the provider side, Medicare and Medicaid; the other half is basically the 28-percent limitation on itemized deductions.

I am curious, to say the least, about that. Those proposed savings are generally outside of health care reform. I would hope that the administration would look to try to find savings within health care reform, because the reason for health care reform is to help improve quality, but also to cut costs, including fiscal costs. I am just curious if you might comment on that. I am especially concerned about the 28-percent limitation. It has nothing to do with health care. There are other tax provisions that have a lot to do with health care, but that one does not. I am wondering about the viability of that provision.

So, if you could just talk a little bit about the provisions in the President's budget related to how we get health reform passed, and if you would also focus a little more on how we find savings within the context of health care reform, because certainly reforming our delivery system is one way to get savings, and so forth. If you could.

Secretary GEITHNER. Thank you, Mr. Chairman. I just want to begin by emphasizing again how important health care reform is to the American economy, to American business, not just in manufacturing, but small business across the country. As many of you recognize, and as you said in this area, one of the most important things we can do is to reduce the rate of growth in those health care costs. That will bring huge benefits to businesses across the country. It is a very important thing to do.

What the President has proposed in the budget is, he laid out a set of broad principles to guide comprehensive health care reform. You have seen those principles. We want to work with the Congress on a package of proposals that meet those principles, and we want to do so in a way that is fiscally responsible, that we can afford to do within our means.

How we do that is, we start the process tomorrow with a very important meeting that brings together leadership in the Congress with health care experts to try to begin a process of comprehensive reform.

Now, you are right to say that the down-payment in the budget proposes to allocate revenues from other sources to help finance this important initiative. We recognize there are other ways to do this. Many of you in this committee have put forward other proposals. We are absolutely committed to working with you on how to produce a package of reforms that meets the President's broad principles in a way that is fiscally responsible for the country. We recognize there are more paths to that than what we laid out in the budget, but we wanted to put on the table—to improve the credibility of our commitment to do this—concrete proposals that would achieve that.

The CHAIRMAN. But you are not wedded to the 28-percent limitation?

Secretary GEITHNER. Let me just say on that, this is important to do. That provision will affect 1.2 percent of taxpayers in America, who account for a modest fraction of charitable contributions. Our view is, that will have modest effects on actual giving. The most important thing you can do for overall charitable giving is to get the economy strong. That has the biggest effect on giving as a whole. So, we think this is a modest effect. Again, what we wanted to do is to lay out very concrete proposals to try to make sure that people understand that we need to do this in a way that is broadly fiscally responsible.

The CHAIRMAN. Is the administration willing to have a discussion with Congress on the employee exclusion, health care exclusion?

Secretary GEITHNER. Of course, we are willing to listen to all ideas that meet these broad principles.

The CHAIRMAN. That is more health-related. It is also very regressive. I might say, if you add it all together, even if you include the payroll tax component, it is about $300 billion a year.

Secretary GEITHNER. One of the principles in the President's budget is, again, to try to preserve our employee-based health care system. As you know from his comments during the campaign——

The CHAIRMAN. Right.

Secretary GEITHNER [continuing]. That is a very important part of our system. We would like to preserve that. But again, we recognize there are other ways to do this, and we want to work with you on how best to put together an effective package of reforms that is fiscally responsible, that meets the President's broad principles.

The CHAIRMAN. I appreciate that. My time is up. I just urge the administration to dig down deeper to try to find viable savings and concentrate on savings within health care reform. Thank you.

Senator Grassley?

Senator GRASSLEY. Would you skip over me?

The CHAIRMAN. Sure.

Senator GRASSLEY. And then take me as the next Republican, or just after somebody else.

The CHAIRMAN. Senator Bingaman, you were the first to arrive.

Senator BINGAMAN. Thank you very much, Mr. Secretary, for your testimony.

Let me ask about the issue of stabilizing the financial system. I think you made the point repeatedly that the way to do that is to get credit flowing again. To do that, we need to deal with the troubled assets that are currently on the books of the financial institutions in this country.

The proposal, as I understand, that you have made as to how to do that is to have this partnership with the private sector. That would involve Treasury making low-interest, non-recourse loans to private investors to buy troubled assets. At least, that is my understanding of it. I think that has been criticized. Paul Krugman said it was an attempt to socialize the losses, while privatizing the gains.

Could you describe for me how this will work? How does this plan actually get these troubled assets off of the books of these financial institutions so that they can get on with the business of providing credit to the economy?

Secretary GEITHNER. Thank you, Senator. Let me just start by underscoring again how important it is to recovery that we get the financial system providing credit again. The Recovery and Reinvestment Act will not be as powerful as it needs to be if the small businesses that would otherwise benefit from those programs cannot borrow to finance the investments they need to support their broad objectives.

Now, to achieve this objective, we need to do several things. First, we need to make sure that banks have the capital and resources they need to lend. Now, in a recession, demand for credit falls, necessarily falls. In a recession that follows a big boom in credit, credit will fall more than it would otherwise fall.

What we have to do is to make sure it does not fall below that economically viable level, because if that happens you are going to see the recession deepen and intensify. But the first really important thing we need to do is make sure the banks have the resources they need to be able to provide credit to the economy. It is hard for them to do that in the market now because of this broad uncertainty hanging over the financial system about the depth and duration of the recession, of the losses that will come, where those losses will fall across a financial system—and breaking that dynamic is very important. For that to happen, the government has to be willing, on a temporary basis, with tough conditions, to make capital available as a bridge to private capital.

The second most important thing we need to do—the basic machinery necessary for credit to work in our country is broken, in some respects. The pipes are clogged, so the securitization markets are not functioning. So a critical second part of our program is to act directly to get credit flowing again, to get those markets starting to open up. The entire small business lending market, the auto finance market, the student loan market, the consumer credit markets, depend on that machinery. So yesterday we announced, jointly with the Fed, a very powerful program of direct financing by the government to help get those assets, get those markets starting to open again.

Now, in addition to that, we are going to lay out, within the next couple of weeks, details of a new program that would marry government financing—in this case from the mix of the Fed and the FDIC—alongside some capital from the government, some private capital, to help provide financing to help unfreeze those markets for legacy assets. Those markets are now not working, partly because of this uncertainty about the recession and the losses associated with that, but they are not really working because there is just no financing available. The absence of financing is partly a reflection of the shortage of capital in the system, and there is just great uncertainty about recession.

So it is good policy, it is good economics, and it is smart for the taxpayer for the government to be willing to, on appropriate terms, provide financing to meet that need. By using private capital along with public capital, you can reduce the risk that the government ends up dramatically over-paying for those assets, taking risks that we cannot understand and manage, doing so at greater cost to the taxpayer.

Our program has these three critical elements, again: a program of capital as a bridge to private capital, very substantial direct support to get credit markets opening up again, and a carefully designed program of government financing alongside private capital to help unfreeze these markets for legacy assets. Those are each necessary and important things to do. Our obligation is to do those in a way that has the least cost to the taxpayer, the greatest protections for the taxpayer, and greatest overall benefit to get credit flowing again. That basic principle trade-off is going to guide what we do.

Senator BINGAMAN. I still have 6 seconds, so let me ask another question. [Laughter.]

Secretary GEITHNER. I apologize. I apologize, Senator.

Senator BINGAMAN. The assets that you are purchasing—am I right, though, that we are going to be providing these low-interest, non-recourse loans to private investors and essentially take on all of the risk on the down-side, while they get the benefit on the upside?

Secretary GEITHNER. Yes. Understand, these questions are hard to answer until you see the details of the proposal, but again, the objective is just the opposite. The objective is to make sure that there is private capital in there to absorb that loss, to help protect the taxpayer from those losses, and again, help us have a program that does not leave us with a risk that we are overpaying for a risk we do not understand and cannot manage effectively.

The government financing will be provided on sensible terms, again, terms so that as markets stabilize, conditions normalize, demands for that financing will normally fade away. So the art in this is to do it in a way that, for the financing the government provides, it is priced so that it is uneconomic, as conditions stabilize, for private investors to continue to borrow from the government. They will want to replace that financing, because it will be more economic, from the private sector.

But you will see. We have laid out the details of our capital assistance program. We laid out the details of this direct lending program to get securitization markets starting to open up again, and you will see us, in the next couple weeks, lay out the details of how we structure this fund to achieve the objectives I laid out.

Senator BINGAMAN. Thank you very much.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. Thank you.

Mr. Secretary, when we met in my office and when you appeared before this committee in your nominee status, I started our discussion by referring to an op-ed piece that appeared on August 14, 2008 in the *Wall Street Journal* by Drs. Furman and Goolsbee. They indicated that an Obama administration would seek to keep the revenue base at or close to the historic average of GDP. At that point, CBO reported that over the past 40 years, it has been around 18.3 percent.

At the hearing that I just referred to, you indicated that, in general, you agreed with Drs. Furman and Goolsbee's target. Now, the budget before us stays very close to that average in the first 5 years, but trends about one-half point above the average in the last 5 years, though it peaks at 19.5 the last year.

So my question: do you disagree with those, including some of the Democratic congressional leadership, who argue that the only path to fiscal discipline is to maintain record levels of Federal taxation as a percentage of the economy? That is number one. Lastly, do you recognize that there is a down side to future economic growth if we return to record levels of Federal taxation?

Secretary GEITHNER. Senator, let me say it this way: it is absolutely critical that, as we move to get recovery back on track, that we commit to the American people that we are willing to get the fiscal deficit on a path to sustainability within a reasonable horizon.

Now again, we propose to do that, beginning when we believe we are confident recovery will be in place, the economy will be growing again at reasonable rates. But when that happens, it is very important that we bring those deficits down. We laid out in the budget a concrete mix of spending and tax measures that will achieve that objective.

Now, as economies recover, revenues rise relative to GDP. You are absolutely right, that you need to look very carefully at the impact of the overall tax burden on the American economy and the effect that it has on incentives for investment and savings and growth. That basic approach underpins the proposals we have made in this budget.

So I agree with you, it is very important we get the budget down to a sustainable level over time. If we do not do that, we are going to be living with lower levels of private investment and higher interest rates. That will be bad for growth. That is a critical imperative. How we do that is important too. We lay out a mix of policies on the spending side and on the resource side that we think will get our economy in a position where we are stronger for the future.

Senator GRASSLEY. All right.

A new question. As modified by the stimulus bill, under section 1202 of the code, 75 percent of the gain realized on the sale or exchange of certain small business stock held for more than 5 years is excludable from gross income, and the remaining gain is taxed at 28 percent. So, effectively it is a 7-percent rise. However, then-Senator Obama, in his election campaign, called for such small business corporation stock to be completely exempt from capital gains taxation. I favor that as well.

An amendment I introduced to do that was not adopted in the stimulus bill. Now, to the President's credit and as a follow-through to his campaign pledge, in the proposed budget, the President again calls for complete capital gains tax exemption on the sale of that small business stock.

However, I would like to suggest a couple of things that the President's proposal could contain to achieve the maximum benefit from his proposal. I do not know the specifics, so maybe he already has these in mind: (1) the proposal should make section 1202 gain not subject to AMT; (2) the proposal should increase from $50 million to $75 million the amount of aggregate gross assets the corporation could have and still qualify as a qualified small business corporation. This is appropriate, given that the $50-million limit was set in 1993.

So my questions are two: would the administration support completely exempting the sale of section 1202 stock from the Alternative Minimum Tax; and would the administration support increasing aggregate gross asset limits from $50 to $75 million to keep up with inflation from when it was originally set?

Secretary GEITHNER. Senator, I just want to begin by saying thank you for emphasizing the importance of that measure. I believe this is a good budget for small businesses. It is very important to point out that 97 percent of small business income occurs to people below the $250,000 a year threshold. It is important to point that out. It is very important to say, as you said, that the budget proposes a zero capital gains rate tax on investments in small businesses.

Now, the specific provisions you made, we are happy to consider. We would like to hear a little more from you about how those could be designed. Again, we are happy to think about them carefully and get back to you.

Senator GRASSLEY. I am done, Mr. Chairman.

Let me just suggest to him that this is one area where, if you want bipartisanship, you are going to get it.

The CHAIRMAN. Thank you, Senator.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

I listened to your entire testimony before the Ways and Means Committee yesterday. Unfortunately, you misspoke. This committee, the Finance Committee, did not approve of the way your taxes were handled. You stated to the Ways and Means Committee that we approved it.

Secretary GEITHNER. No, Senator. Could——

Senator BUNNING. Yes. Well, you can play both tapes, and you will find out that you misstated.

Secretary GEITHNER. Senator, what I said is that I had disclosed fully to the committee and the committee had put that into the public domain. That is the only thing I said yesterday.

Senator BUNNING. No. The word "approved" came in.

Secretary GEITHNER. Not by me, but——

Senator BUNNING. Yes, by you.

Secretary GEITHNER. No.

Senator BUNNING. Well, I mean, we can get the tapes of both committees, and you will find that we did not approve. We questioned you on it. Some were very unhappy with it and some just passed it on. So, that is over.

You say the budget does not raise taxes on American families making less than $250,000, but the budget also has a cap-and-trade system that will auction off emission permits to tip the scales in favor of less-efficient and more costly energy sources. That will result in higher costs for energy and manufactured goods for all Americans. How does that not break the President's promise not to raise taxes on Americans making less than $250,000?

Secretary GEITHNER. Senator, the President believes, as do a large majority of the American people, that it is very important that we reduce our dependence on foreign oil and we move now to put in place a foundation to encourage greater efficiency in the use of energy and greater use of clean energy technologies. Now, you cannot do that without changing the incentives that Americans face for how they use energy. The cap-and-trade proposal——

Senator BUNNING. Well, we could argue about how we are going to get there.

Secretary GEITHNER. True. But I think the important point I want to make is that to do that requires that you change the incentives for how Americans use energy. Now, in the President's proposal, which of course we have——

Senator BUNNING. We have been doing that in 2005 and 2007. Both the two energy bills that we passed did exactly what you are proposing.

Secretary GEITHNER. Well, we are going to have to do dramatically more in that area, I think, to achieve this broad objective.

Senator BUNNING. I agree, because all of the things are not included.

Secretary GEITHNER. Right. And what the President proposes is that we work with Congress on a comprehensive cap-and-trade proposal. As you know, the resources that that proposal will raise are going to be devoted to making the Making Work Pay tax cut permanent—this will affect 95 percent of working Americans—to devote additional resources to helping facilitate this transition to cleaner energy technology, and, if it raises additional resources, we will devote those to helping to directly affect those individuals who might face higher energy costs if they do not change their behavior of how they use energy. But we believe that over——

Senator BUNNING. Then the ability to trade or to auction off emission permits is a way that the less-efficient are more rewarded than the more-efficient, because they can go and still not comply and buy the emission permits that are available.

Secretary GEITHNER. Senator, the cap-and-trade system has been applied successfully in our country, in parts of the country, to reduce acid rain. It has been used in other countries with substantial effect, too.

Senator BUNNING. Well, but there's a cost involved there.

Secretary GEITHNER. But——

Senator BUNNING. Because I live in Kentucky, so I pay the cost.

Secretary GEITHNER. Well, Senator, again, what this proposal is designed to do is to change the incentives Americans face for how they use energy so that——

Senator BUNNING. I have one more question. Go ahead.

Secretary GEITHNER. All right. So that, again, we make more progress in energy independence and improving energy efficiency, and facilitating a transition where we are relying much more heavily on clean technologies.

Senator BUNNING. All right. Thank you.

I have one more question, and it involves LIFO. This will disadvantage American companies, such as retail companies, and particularly companies in my State of Kentucky, the bourbon industry. LIFO minimizes artificial inflation gains and accurately reflects replacement costs.

One example of how it is used, in the Kentucky bourbon industry, whose aging process, under Federal law, requires that bourbon be held in inventory several years before it can be sold, repealing LIFO would harm U.S. companies and favor their foreign competitors. At a time of economic distress when we are trying to encourage more U.S. manufacturing, the repeal of LIFO moves in precisely the wrong direction. Why would we want to repeal LIFO now, after it has been in place for more than 7 decades?

Secretary GEITHNER. Senator, I have heard a lot of concerns about this specific provision. There are a significant number of tax professionals who believe this is good tax policy, good economic policy. But I have heard from many people a lot of concerns about what impact this might have, and we are going to have to look carefully at those concerns and the extent to which we can mitigate those concerns. But I understand them, and would be happy to spend more time understanding specifically the concerns you are worried about in terms of how they affect particular industries.

Senator BUNNING. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Secretary, I strongly support the views Chairman Baucus has expressed today, that starting tomorrow at the health care summit, put these Federal health care tax rules on the table. It is clear to me that Democrats and Republicans alike agree that these rules are a $250-billion monument to regressivity and inefficiency.

If you do what Chairman Baucus has suggested today, it seems to me you get a two-fer. One, you get savings immediately on the health care side while still protecting the middle class and honoring the President's promise that people can keep the coverage they have, and second, you are going to get savings in the future because you change people's behavior, so in the future President Obama and other presidents will not have to come back and say, we need money from non-health care accounts to fund health care.

Now, you have said you are going to study this. That is constructive. But what I would like to know is, do you personally share the view that these Federal health care rules, as constituted today, are regressive and promote inefficiency?

Secretary GEITHNER. Senator, what I personally believe is, it is critically important for our country that we come together on a comprehensive health care reform package that meets the broad principles the President laid out, and does so in a fiscally responsible way.

Now, you and your colleagues have shown great leadership in identifying a very carefully designed way of meeting that objective within the framework of the health care system. As I said to you before, and I will say it again now, we will look very closely at those ideas and those proposals.

Senator WYDEN. It is not about looking at my ideas, Mr. Secretary. Economists, Senators—I mean, it is almost a universally held opinion now in terms of the scholarship in this area, that these rules are regressive and promote inefficiency. I just want to know if you disagree with those kinds of arguments.

Secretary GEITHNER. Well, I——

Senator WYDEN. Whether it is Milton Friedman——

Secretary GEITHNER. Right.

Senator WYDEN [continuing]. Whether it is Bob Greenstein. I mean, literally, across the political spectrum, people agree with this.

Secretary GEITHNER. Senator, I agree, there is broad support among economists——

Senator WYDEN. Great.

Secretary GEITHNER [continuing]. For what you laid out. I agree with that. I think what we want to do is fix this. There are a lot of things we are going to have to change. There is lots of room for improvement, lots of ways to solve this. We want to work with you on how to do it.

Senator WYDEN. Very good.

Let me ask you a question about taxes. In the last decade, there have been thousands and thousands of changes in the tax law. It comes to three for every working day now. It is very harmful to businesses who need certainty and predictability to grow to face this relentless blizzard of tax law changes. Are you at all concerned about how the effect of the many more tax changes you propose now will impact businesses that want to grow in 2009, knowing that they are going to face more proposed changes in 2010 when tax reform comes along?

Secretary GEITHNER. Senator, I do agree with you that there are a wide range of aspects of our tax code that add to uncertainty, and that uncertainty makes it hard for businesses to make decisions long-term. I completely agree with you about that. As we work together towards ways to improve our overall tax system, tax code, addressing that question will be a critically important thing.

The most important thing we face today is to get recovery on track, figure out a way to make these long-term improvements in health care, education, and energy infrastructure in ways that are fiscally responsible. The budget proposes a very comprehensive set of changes designed to achieve that. It is not going to satisfy everybody. It will come with other concerns. But we think, as a whole, this package of changes will improve our fundamentals as a country and leave the economy in a stronger position going forward.

Now, the budget does not solve all problems. There are a whole range of other features of our tax code that are not addressed in this budget that we would like to build consensus on addressing. I hope we have the chance to begin that process with this committee and your colleagues in the Congress.

Senator WYDEN. I hope you will also say, with your tax changes, though, that you are really setting the table for tax reform in 2010, because you look at all the changes people have gone through just in 2008 and 2009. If you are sitting somewhere in Montana and

Oregon, you are trying to grow your business, you have already had thousands that you have had to assimilate in the last few years.

Then you are facing more proposed in 2009, with tax reform coming at you in 2010. The first thing you do is, you say I am going to be a little cautious about investing, knowing that perhaps what I am doing today may be affected by changes that are coming up literally in a matter of months.

Secretary GEITHNER. True. But I think the overall impact of these changes, again, are good for business, they are good for investment, and we are being very clear that we are not going to raise taxes until recovery is firmly established, and we are very clear about what taxes will change as we emerge from recovery. So, you are right that certainty is very important. I am sure we can do better. I hope that we are beginning to lay that foundation for broader reform.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator, very much.

Senator Enzi?

Senator ENZI. Thank you, Mr. Chairman. I, too, want to emphasize how pleased I am that there is health care reform emphasis in the budget, and also some recognition that there are some health care reform costs involved in it. I also want to say how much impressed I am with the leadership of Senator Baucus on health care reform. The Senate has been involved in it for some time.

But that is not where I am going to ask my questions. I have another favorite area, which is workforce training. I have been trying for 4 years to get some more flexibility built into workforce training so that we could train people to some of the higher-skilled jobs that we are now exporting to other countries. It ties in with the goal of creating or saving 3.5 million jobs, a marvelous goal. Now, I understand creating jobs. What I wondered was how you rate the saving of jobs. What is a saved job?

Secretary GEITHNER. Well, that is a loss avoided, or a rise in unemployment avoided by getting growth back on track. Again, without a very substantial program of investments and tax incentives, we would face the prospect of a much deeper recession, much higher levels of unemployment. So the President's commitment is framed that way because our first obligation, again, is to reduce the risk of further job losses and lay a foundation for recovery in employment.

Senator ENZI. But are all jobs not kind of tenuous at the moment, so all 130 million, or however many there are, are being saved by what we are doing?

Secretary GEITHNER. Well, I am not sure I fully understand what we are debating. I think that you are right, the economy is going through a——

Senator ENZI. I am just asking for more emphasis on the created jobs rather than the saved jobs.

Secretary GEITHNER. Yes. I——

Senator ENZI. So that we are expanding the skill levels of the people whom we are employing.

Secretary GEITHNER. Yes.

Senator ENZI. And I hope that the administration will take a look at that Workforce Investment Act to get that flexibility in there, because those are the people who are without jobs. The ones who still have jobs that are tenuous, we need to do everything we can to save those. But——

Secretary GEITHNER. We want to save them, we want to create more jobs, and we want to make the average American worker more productive in the future, not just through things like worker training, but also by improving basic quality of education outcomes. I absolutely share that objective, and we would be happy to work with you on that specific provision.

Senator ENZI. Thank you. I am just trying to keep the transparency in there.

Secretary GEITHNER. All right.

Senator ENZI. I need to talk to you about a very small part of the budget, but one that affects a number of States, including the chairman's State. About 3 years ago, we had a tax that was about to expire, and we put together a rather tenuous group of people to extend that tax and solve some other problems, one of which was the problem of orphan miners' health insurance. That orphan miner does not mean they do not have parents, it means that their company no longer existed. But we were able to save that.

We were able to move up the amount of time that it took to do reclamation in some of the States that had very little money coming in, and we encouraged the other States that had been responsibly taking care of their problem to look at some other things, like more efficient energy, cleaner energy. I think the States have been doing that.

But there is a provision in this budget that now jerks the money away from those States that had been responsibly doing it and ends their alternative, clean energy, or additional energy projects. I am hoping you will take a look at the history and see how tenuous that was, and see how widespread it is. It is such a small part of the budget, I am sure we can work out something. But all I am asking is that you take a look at the history and see what——

Secretary GEITHNER. I will take a look at it and come back to you with a response.

Senator ENZI. Thank you. In my remaining few seconds here, I am going to express some concern for small businessmen. I think that quite a few of the people that have already been in this $250,000 tax level are ones who have S corporations, limited liability corporations, single proprietorships, other businesses where the money from their business flows right to their bottom line on taxes, even though they have to plow a lot of that back into their business to keep their business going. It will be a huge blow to them, and their businesses, and their ability to stay in business if the housing, the charitable giving, and the increased taxes hit them.

Is there any way that we can exclude the small businesses on this? Is there any way we can give them some kind of relief? I am just asking.

Secretary GEITHNER. Senator, as I said before, our estimates are based on the proposals in the President's budget to allow the marginal tax rates at the very high end, above $250,000, to return to their 2001 levels. That specific proposal, we believe, will affect a very small percentage of small business owners. The estimates that I was given yesterday by independent analysis were roughly 3 percent of small business owners.

I think it is important that we look at the overall impact, again, of these proposals in the budget on the basic environment in which businesses operate. I think the combination of the fact that most small businesses will see no increase in taxes, or some will see a reduction in taxes, combined with what we are going to try to do to health care costs, combined with the other broad incentives for investment when we were creating this budget, is a strong and powerful package of incentives because we believe, as you do, that small businesses are a critical source of not just innovation and vitality in our economy, but of job growth.

So it is a critically important objective, and we are open to work with you and your colleagues on other ways, including the ones that Senator Grassley suggested, and we will look at all of the proposals to help meet that, because we share the importance of this objective.

Senator ENZI. Thank you. My time has expired.

The CHAIRMAN. Thank you very much, Senator.

Senator Nelson, you are next.

Senator NELSON. Mr. Secretary, good morning to you. On the question about folks not paying what they owe in their taxes, particularly some of the banks that have used the offshore tax schemes—and that is estimated somewhere in the range of $40 to $70 billion a year that they are not paying—that is a heap over the 10-year budgeting period that we have, $400 to $700 billion.

A recent GAO study showed that of the 100 largest U.S. publicly traded corporations, that 83 have subsidiaries in offshore tax havens. For example, Citigroup, which by the way is one of the major recipients of bailout funds, has 427 subsidiaries in tax havens, and there are 90 of those subsidiaries in the Cayman Islands alone.

What can we do? And I do not say "you," I am saying "we." I have filed a bill with others, including Senator Levin, to address this issue. But what should the U.S. Government do to close these loopholes before we continue to ask taxpayers to bail them out, when they are not paying their fair share of taxes?

Secretary GEITHNER. Senator, I share your concern, and I think you are right to point out it is not fair to people who pay their taxes for people to continue to have the ability to evade U.S. taxes by taking advantage of offshore tax havens and a range of other provisions in current law which makes it possible to evade U.S. taxes. That is why, in the budget, there is a clear commitment by the President to come to the Congress with a comprehensive set of proposals for reducing international tax avoidance.

As part of that, we are going to have to bring a much more ambitious effort to deal with offshore tax havens. That is not going to be enough, though. There is a range of other things that are in the tax code now which create incentives to shift investment jobs overseas, create other opportunities to evade U.S. taxes, and we are going to come and give you the best set of proposals we think we can come up with to try to meet this broad objective.

I think you are right, it is not fair, particularly given the scale of the fiscal challenges we inherit and the important long-term investments we are going to need to make. The only way to get ourselves back to a fiscally responsible path is do a better job of dealing with this challenge.

Now, you know in the budget there is a very substantial request for improved enforcement resources. The IRS and the Commissioner are going to be in a position to come and explain in more detail how he plans to use those. But we are going to look at the full range of ideas, including the ones you have referred to in your bill. Of course, this committee has shown great creativity and leadership in this area in the past, and we would like to build on those suggestions.

Senator NELSON. That is wonderful news and a refreshing attitude.

Mr. Chairman, this, of course, will be a matter in front of your committee, and I value your leadership on addressing these tax loopholes.

The CHAIRMAN. It is a very important question, and I am very glad, frankly, this is being addressed more forcefully by this administration.

Senator NELSON. And very forcefully.

The CHAIRMAN. It is a big problem. Yes.

Senator NELSON. And I am very appreciative.

The CHAIRMAN. Right. There are lots of ideas and a lot of them sound good on the surface, but the main point is to be effective in closing down these loopholes.

Secretary GEITHNER. I think the hard thing is, of course, everybody is for closing the tax gap.

The CHAIRMAN. Right.

Secretary GEITHNER. But when you look at the specifics, sometimes that enthusiasm fades. So, we need to make sure that we are putting together as comprehensive and as carefully designed a set of proposals as we can. We have no alternative but to do a better job in this area.

The CHAIRMAN. Now is the best time to do it.

Secretary GEITHNER. Right.

The CHAIRMAN. Thank you.

Senator NELSON. May I, in my remaining time, Mr. Chairman, just ask one more question?

The CHAIRMAN. Certainly.

Senator NELSON. What we have, as I see on the issue of housing, we are having voluntary loan modifications made by banks, but they are putting them back into a loan modification. It may be another adjustable rate mortgage that, when the time comes, is not going to solve the problem. We have this kind of revolving situation that is delaying the inevitable.

The housing plan that you put forth has incentives for voluntary modifications to those fixed mortgages. What can we do to put the protections in there to help the homeowners from not being forced or encouraged to sign up for another mortgage that they cannot afford?

Secretary GEITHNER. You are absolutely right that many of the modifications that have been done to date do not fundamentally improve the overall debt burden of the borrower and will still leave them in an unsustainable position. What this program does is try to address that.

So the program provides a powerful set of incentives to produce more affordable mortgages for people who meet these carefully designed eligibility tests, because we do not want to be devoting taxpayer resources to support homeowners who do not need the assistance, nor do we want them to be directed to homeowners who really knowingly borrowed dramatically beyond their means.

But what this proposal does is provide, as I said, a powerful set of incentives, incentives of both types—what I might say, persuasive force and some economic inducements—to provide substantial improvements in affordability for people who meet this important test, where, with those changes, you are going to be put in an economically viable position, able to stay in your home in that case.

Now, that is not the only thing this plan does. Can I just, Mr. Chairman, quickly——

The CHAIRMAN. Briefly.

Secretary GEITHNER. I am sorry. This is very important. Critical and important to the rest of the program the President announced is to try to bring mortgage rates down for all Americans. The role that Fannie and Freddie play in our housing market is a critical part of that.

We announced a significant set of measures to achieve that objective and, for the first time, we let a new program that would help Americans that have somewhat higher than typical loan-to-value ratios take advantage of the reduction in mortgage rates already by refinancing, where they previously did not have the opportunity to refinance. Those things, together, we think will help address this acute crisis that is causing so much damage.

The CHAIRMAN. Senator Snowe, you are next.

Senator SNOWE. Thank you, Mr. Chairman.

Mr. Secretary, the President said that, in order to have a full recovery, then you have to really resolve the credit crisis. You have acknowledged in your statement very emphatically that the credit crisis has not been resolved, that the dynamic continues to be that the banks simply are not lending. That is difficult for my constituents, and I think it is true of most Americans, as to why the banks are not lending. I do not know if we know what they are lending, if they are lending, which banks have been participating in the top program, are refusing to disclose the data on whether or not they are lending.

So I would like to ask you exactly, what do you know, what can you tell us, and more importantly what can you tell Americans, in terms of, when do we expect that this credit crunch is going to be resolved, or at least eased? Because at this point there is no discernible evidence on Main Street, certainly in my State. I think that is true across the country. That is deeply disturbing, frankly, because months have gone on. We have obviously given $250 billion to banks specifically for this purpose, not to mention the multitrillions in all venues to rejuvenate the economy.

So what can you tell us in this regard about, what is your timeline and measurement for the credit crisis to ease, and whether or not the banks are disclosing exactly what they are doing with this money?

Secretary GEITHNER. Senator, this is critically important, and everything we are trying to do to get the economy back on track depends on trying to make sure that our banks are lending and credit markets start to open up again.

As part of the program we have initiated, we are going to put in the public domain much more detailed reporting, bank by bank, by TARP recipient, what is actually happening to their lending and overall balance sheets, so you will be able to see, the American public will be able to see, for those institutions that get assistance in this context, what is actually happening to lending.

As a condition for new assistance, we are going to make sure that they have to give us a report in advance that explains how they are going to use that assistance to increase lending above the levels that would otherwise have prevailed, and you will be able to see that on an ongoing basis.

Now, across the country, in our very diverse mix of banking institutions, you have some institutions that were not part of the problem and are strong and are going to expand lending and are growing, but you have other parts of the system where they are going to need more capital in order to help support recovery, and our program is designed to provide that.

Now, you are absolutely right that this is still a deepening recession and a deepening credit crunch, but I just want to point out that many costs, many measures of borrowing costs, have come down. Mortgage interest rates have come down, borrowing costs are lower for banks than they would otherwise have been, and you are starting to see some aspects of the corporate lending market start to open up again.

But we are at the beginning of that process, and it is going to take more efforts by us to do that. I think the best measure that you are going to see of improvement is, again, when those borrowing costs start to come back down to more normal levels. That will be the critical test of success, and that is going to take more time, but it is going to require more carefully designed, appropriately conditioned capital from your government, as well as a much more powerful set of direct credit supports to the markets that are critical for consumers and small businesses, and that is what we are doing.

Senator SNOWE. Well, are you planning to release the list of all 450 banks that have received assistance under the TARP program, and what they have done with that money?

Secretary GEITHNER. Well, we produced the report——

Senator SNOWE. Going retroactively as well as prospectively, all the banks?

Secretary GEITHNER. Right. Well, we are putting all the terms of past assistance on the website for people to see it, to be able to see the recipients and the precise terms. We released just last week a new report that looks at the largest banks in the country, which account for most of the lending, so you can see on, I think it is a monthly basis, exactly what is happening to lending by them, detailed by institution. And going forward, as a condition for any new assistance, you are going to see much more detailed reporting requirements, so, again, you and your colleagues and the American people will be able to see, bank by bank, what is actually happening.

Now, again, it is very important to point out that in a recession, particularly after a huge credit boom like this, demand for credit by even the strongest companies will slow, and you are seeing that happen. What we need to do is to make sure that the credit crunch does not deepen the recession. That requires more action by the government because, in a crisis like this, the private sector is not willing to take risks that would otherwise be economic.

Senator SNOWE. Well, it is going to undermine the value of the stimulus plan once it is under way.

Secretary GEITHNER. Absolutely.

Senator SNOWE. And you said yesterday that this crisis will be much worse if we do not move quickly. I think we have moved very quickly on all fronts here since this whole scenario unfolded last fall with, some say, exposures up to $9 trillion. So I do think that it is absolutely vital that this gets under way, and you have projected growth for 2010, or at least the Office of Management and Budget, of 3.2 percent.

So obviously that is predicated on certain assumptions of what is going to occur this year, so that is why it is important to let the American people, and all of us, know exactly when you think that is going to unfold, because that is twice the growth rate that the Congressional Budget Office is projecting for 2010. That is a quantum leap from a 6.2-percent contraction in this last quarter and minus 1.3 percent projected for this year.

The CHAIRMAN. Senator Cantwell?

Secretary GEITHNER. You are absolutely right. The economic recovery depends on financial recovery.

Just one thing about the forecast.

The CHAIRMAN. Very briefly.

Secretary GEITHNER. The administration's forecast is within the range of estimates that CBO has produced to try to measure the effect of stimulus on the forecast. It is also within the range of private forecast estimates for 2010, and most private sector economists expect to see the economy start to recover in the second half of this year, but it will depend in part on how quickly we move, not just to get stimulus in place but, as I said, to get more support into the financial system again.

The CHAIRMAN. Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman. My colleagues have asked so many questions, Secretary Geithner. I feel like I have many myself, and I could go either talking about the bailout or talking about the tax code, so hopefully I can get through a couple of these.

First of all, AIG has been bailed out 4 times since September, to the tune of $160 billion: September 16th at $85 billion; October 8th at $37 billion; November 10th at $40 billion, I believe; and then recently, March 2nd, $30 billion, is the newest proposal.

Why has Treasury not come forward and said who are the affected counter-parties, the people who are most affected by the collapse, so that we know why we are doing this?

Secretary GEITHNER. Senator, thank you for asking this. AIG got itself in this position because there was no effective oversight, where it took on enormous leverage in a large hedge fund attached to a set of very well-designed, well-performing insurance businesses. This company operates in countries around the world. It is an enormously important entity in this context. Its failure, in the judgment of your government, would have caused catastrophic damage to the savings of Americans, to interest rates, to pension values, and you would have seen—and I share this judgment—much greater damage than even we saw with the failure of Lehman.

Now, the world——

Senator CANTWELL. If you could just clarify more on that, because you are saying basically it would have been bad for America. What I want to know is, who would it have been bad for and how would it have caused the problems for common Americans and their savings?

Secretary GEITHNER. The biggest effects would have been not on the direct counter-parties to the affiliate of AIG that sold a bunch of credit protection. The biggest effects, and the most troubling effects, like what you saw in Lehman—but I think it would have been bigger in this case—would have been on broader confidence in the financial system, in asset values, in interest rates, and in willingness of people to take risk in exposure to financial institutions. That would have caused much more damage. That is harder to quantify, harder to understand.

But in the AIG case it is very important, because millions of Americans, here and around the world, depend on AIG for insurance policies and a range of different types of savings products. So the judgment your government made in that context was—and I think it was the right judgment—that the effect on confidence would have been very dramatic, I think more dramatic than even in the case of the failure of a major investment bank.

Senator CANTWELL. Well, Secretary Geithner, with all due respect, I think that is the question of the day: confidence in the plan. The plan is slowly dripping out and people do not understand where it is going. They do not understand the AIG bailouts and where and who it was benefitting, they do not know what specific industries and companies we were helping to preserve those opportunities for Americans, and they do not understand the plan overall.

Secretary GEITHNER. Senator, just again on AIG, because it is very important on AIG, the world has gotten dramatically worse since September of 2008. You are seeing that across the financial system, across life insurance companies generally. The world is more fragile today even than it was then, and therefore the consequences of allowing a disorderly failure of AIG would be at least as damaging today as it was then.

It is our judgment that the best way to protect the American economy from that risk is to stabilize this institution and let it be in a position where it can pursue a restructuring over time that leaves us, and the taxpayer, better overall. That is why we are doing this, because of those broader benefits.

We believe this is the least-costly way to protect the economy from that. I wish it were not so. It would be much better for us, and for you, if we had another alternative to this path that would contain the damage to the economy as a whole. But that alternative does not exist.

Senator CANTWELL. I am not sure that we are getting to the point that I wanted to get to, so I think what I will do is I will skip to something else. Then maybe you and I could have a longer conversation about that. But I do think that people really do want to understand the specifics behind that particular bailout, and more details about the plan.

This particular proposal in the budget on taxes. I have a question in the sense that there is a lot of junk in the code. My colleagues have been bringing that up. Some people do not pay their taxes, but obviously there are a lot of loopholes. Some other people have been bringing that up.

Why not look at a broader approach to the tax policy than coming in with this proposed change to the marginal rates? Are you convinced that we would have to have this high of a change to the marginal rates if, in fact, we would have taken a more systemic approach to this problem? Coming from software, when you have errors or bugs in the code, it is a problem. It affects everything in the system.

That is where we are today. We have a lot of errors and a lot of bugs in this code, and how do we know that this plan that you are proposing would not be less impactful if we had actually taken a larger approach to closing some of those and cleaning up some of the problems in the tax code, something I know the chairman has talked about, doing a major overhaul of the system.

Secretary GEITHNER. Well, we do propose a lot of changes in the tax code, particularly things that allow people to take advantage of ways of avoiding U.S. taxes. So we are proposing a lot of changes to those. But you are right.

As I said earlier, we are not proposing, in this budget, comprehensive tax reform, but we would like to begin the process of working with you and your colleagues on other changes we can put in place, not just to simplify the tax code, not just to provide more certainty to business, not just to make it more fair, not just to make sure it provides better incentives for growth, but so that we are making a more efficient overall system. But we could not do that kind of comprehensive reform in this budget, so we would like to begin that process with you. We are not claiming, of course, in this budget to try to take on those myriad of other problems, but we would like to begin that process with you.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow?

Senator CANTWELL. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

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

Mr. Secretary, welcome. I would also reiterate what our chairman has indicated about health care, and I appreciate the focus and how critically important this is to the economy and to jobs in the United States, and certainly to manufacturers as well.

I do want to take a moment. A lot of important questions have been asked today, a lot of issues on our minds, but I am going to zero in on something—not surprising to you—which relates to the auto industry and auto financing and people being able to get loans and so on. And I do want to, just as an aside, indicate, with all of the dollars that Senator Cantwell was talking about being asked for for AIG, the relatively small amount of money that General Motors and Chrysler are asking for by April of $6.5 billion looks like a rounding error compared to AIG and a number of other things, and will keep 3 million people working in this country. So, editorial comment.

But I do want to talk to you about the credit crisis that has brought us to where we are, because it is a global credit crisis that has made it impossible to raise capital for the auto industry, or manufacturers in general, to invest in the technology we want them to invest in, to get to the electric vehicles, or to even do daily operations. We saw yesterday in the papers that Japan is going to move forward with money for Toyota because of the global credit crisis. So all of the companies in the world are facing this same challenge, regardless of how people feel about individual companies.

But our dealers and suppliers do not have the credit that they need to finance inventory, as you know, or to cover capital costs. Financing companies lack funds to support dealers, to make consumer loans. With the consumer demand going down for buying the second-largest purchase that a family buys, which is their automobile, and the economic crisis we have today, it is really a perfect storm.

So I appreciate what you announced yesterday with the TALF program, the Term Asset-Backed Securities Loan Facility program, because it is very important to get credit flowing again.

However, we have a problem. I do not know if this is something that you yet have been focused on, but the reality is that the program, as put forward, requires a AAA rating from two rating agencies. Given the uncertainty and the ongoing discussions right now with the industry and with the government, some of the rating agencies have declared they cannot affirm or assign a AAA rating for securitizations of dealer floor plan financing lines, which obviously is a very serious issue at this point. In other words, they cannot use it. Even though you have announced it, they are not able to use it. So I am wondering, how will TALF help issuers of dealer floor plan securitizations that cannot meet this requirement at this time?

Secretary GEITHNER. Senator, thank you for raising that. TALF will help, but it is not going to solve all these problems. I think that what we need to do, and what we are working on, is trying to make sure that these companies lay out a restructuring plan that puts them on a path of viability without government assistance over the longer term. That is a necessary condition for addressing this crisis in the automobile industry. We are also looking, though, directly at whether we can, as part of that, do other things to help get directly at these financing problems that are affecting both suppliers and dealer inventory financing.

So we are looking very carefully at a range of different ways to address that. You are right to say that we need to look at that alongside trying to help facilitate the kind of substantial restructuring the industry needs as a whole.

Senator STABENOW. We know that the challenge for them is they have to keep changing their numbers downward in terms of auto sales. That is what is driving their ability to put forward various options.

Secretary GEITHNER. Right.

Senator STABENOW. And you have seen the options. So the question of whether or not this new financing for auto loans can actually go to financing arms is absolutely critical. When we look at the fact that the TALF program is using 3 rating agencies, SEC relies on 10 different rating agencies. So I am wondering why the Fed is choosing 3 versus 10, and would that not give us the ability to more quickly help in this area if we were to use a different approach on the rating agencies?

Secretary GEITHNER. Well, I will pursue that specific question with my colleagues at the Fed and have someone get back to you on whether that is something we can address. But I think the really important thing is, we are going to have to look more comprehensively as we try to see whether we can responsively help facilitate the kind of path to long-term viability that is going to be critical for the industry as a whole. But addressing the financing things, you are right, is absolutely central.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

Senator HATCH. Thank you.

I am next, according to the chairman.

Mr. Secretary, welcome to the committee. I do not know how you can do all your work and keep testifying on Capitol Hill like you have. It just seems to me it would be better to keep you working. But now that you are here, we might as well ask at least some tough questions.

You stated that the President is determined to cut the $1.3-trillion deficit by at least half in 4 years. The Congressional Budget Office estimates that, if we did nothing at all, the deficit would decrease by 90 percent. Now, how can President Obama claim that he will decrease the deficit by half when the deficit will automatically decrease at a much higher percentage?

Secretary GEITHNER. Senator, I have not looked at the details of that study, but I do not think it is the right way to think through this.

Senator HATCH. I think you need to look at the details.

Secretary GEITHNER. Yes. I will look at the details of it.

Senator HATCH. If that is true, why are we going through this? I mean——

Secretary GEITHNER. Framed that way, it cannot be right.

Senator HATCH. Well——

Secretary GEITHNER. If we do not get growth back on track, we will face higher long-term deficits. The fiscally responsible thing to do now, if you worry about long-term sustainability, is to do what we can to get recovery established and the economy going again.

Senator HATCH. All right. I will accept that. I would like you to look at it, and would like you to answer that for me and get me your criticisms of that particular approach.

Now, you indicate in your testimony that you recognize that many small businesses are operated as sole proprietorships or through partnerships or other flow-through entities; therefore, you obviously realize that the individual tax rates have a profound effect on those businesses. Your testimony says that 97 percent of small businesses would not be affected by the President's plans to increase the tax rates on single individuals making over $250,000, or families making over $400,000.

Now, it may be true that a high percentage of small businesses may be unaffected by these changes, but is this not because there are so many millions of small businesses that are very small and have just one, or maybe a handful, of employees? Now, if you were to analyze the income earned by small businesses, would the answer not be quite different?

The data I have seen, which is from the Treasury, from your organization, indicate that between 7 percent and 9 percent of small businesses pay tax at the top two marginal rates, but that these taxpayers account for between 57 percent and 72 percent of flow-through business income, and between 75 percent and 82 percent of taxes. Of course, these larger small businesses are the ones with most of the jobs, too.

Now, can you and the administration honestly tell me that you believe the proposals that would raise the tax rates of individuals will have no negative effects on job retention or creation of these small businesses that pay taxes as individuals?

Secretary GEITHNER. Senator, I would like to get back to you on those specific comparisons and give you a comprehensive analysis——

Senator HATCH. Well, see, I think it is one thing to say that 97 percent are really not going to be affected when 5, to 7, to 9 percent are almost everything it happens for.

Secretary GEITHNER. Right. I want to do this carefully. But I do believe, and I think it is important to point out, I think this budget is good for small businesses. It has some very important beneficial effects for them. The best thing we can do for the economy as a whole is to get growth back on track, and a critical part of that is to try to address these crippling health care costs. So it is important to look at the entire package, not just the tax provisions.

Senator HATCH. No, I agree. But I also agree that you are oversimplifying the small business aspect, and I would like you to clarify that.

Secretary GEITHNER. Right. I will come back to you on that.

Senator HATCH. I think you need to clarify that.

Now, one last question, because my time is running out. In your testimony you state that the Obama administration inherited the worst fiscal situation in modern American history. From 2003 to a month ago, you were president of the Federal Reserve Bank of New York. Now, I am happy to have you here, but this is a tough question. You were president of the Federal Reserve Bank of New York, which implements monetary policy, supervises and regulates financial institutions, and helps maintain the Nation's payment systems.

Now, starting in September 2008, bank after bank, most of them headquartered in New York, began to fail: Lehman Brothers, Bear Stearns, AIG. The list goes on and on. Now, I bring this up because the administration keeps beating that drum, that it "inherited failed economic policies from the past 8 years." Now, the economy for the past 8 years, while not strong, was at least moderate and only began to fail in the past couple of months.

So I can only assume that the administration is referring to the recent collapse of the financial markets. As head of the Federal Reserve of New York, were you not an integral part of that failed economic policy? Is it not a little bit unfair to blame this all on the prior administration? Except, you raised the issue that there could have been more oversight. But you were the overseer.

Secretary GEITHNER. Senator, thank you for raising this. Just a couple of things. I have said before——

Senator HATCH. These are important things to me.

Secretary GEITHNER. Absolutely. I have said before, before this committee, and am happy to say it again now, that there were systematic failures in supervision and oversight across our financial system.

Senator HATCH. It is not fair to blame the prior administration for everything.

Secretary GEITHNER. And a lot of things contributed to this crisis. A lot of things, not just on the financial, but on the fiscal side, contributed to this. But I just want to point out, just because you mentioned this specifically, the Federal Reserve was not given responsibility for overseeing investment banks, insurance companies, hedge funds, and non-bank financial systems that were a critical part of making this crisis so intense. But you are absolutely right.

Senator HATCH. You seem to be blaming us up here.

Secretary GEITHNER. No, no.

Senator HATCH. Wait. I think you are right.

Secretary GEITHNER. No.

Senator HATCH. I think we could have done a better job.

Secretary GEITHNER. Well, I think we all could have done a better job, and we are going to have to do a better job. We are going to come with comprehensive reform of the oversight structure of our financial system, because we have this deep obligation, which I feel very strongly about, to make sure that a crisis like this does not happen again. But it is going to have to require comprehensive changes in how we oversee, much more conservative oversight of the core part of our system, and it is going to require better supervision of banks as well.

Senator HATCH. All right.

Senator Carper is next. Thank you very much.

Senator CARPER. Thank you, Senator Hatch.

Secretary Geithner, welcome. You are a busy man, and I know you have a wife and children. Do you ever get to see them?

Secretary GEITHNER. I do. Thank you very much. They are very important to me. I see them as much as I can, less than I would like.

Senator CARPER. You will know you have been away too long when you come home and your children say to you, daddy, you look older than your pictures. [Laughter.] I recall my children saying that to me a time or two earlier in their lives. Thank you for your service.

I worry about the administration, especially with Treasury, your ability to get your team around you. Can you just give us an update on how we are progressing there? Your Deputy Secretary, Under Secretaries, Assistant Secretaries. How are we doing there? Because obviously you need help.

Secretary GEITHNER. We are making some progress. We hope to come before the committee soon with a full slate of very strong people, and we are doing this carefully, as you would expect, and trying to make sure that we have the best talent in the country, frankly.

Senator CARPER. All right. Good.

I appreciated the opportunity to be with you last week at the White House at the budget summit, and we talked a bit then about an issue that you mentioned today already, and I think Senator Nelson raised it, too. The issue is the tax gap. I think it galls most people who pay their taxes, pay their fair share, to know that there are some—in fact, quite a few—who do not pay much, and in some cases, nothing at all.

We know, as I mentioned last Monday, if monies are withheld for taxpayers for our income, there is almost 100-percent compliance in terms of actually paying our taxes. If there is reporting for our income, it is over 90 percent or more. In cases where there are businesses or individuals who work with a cash economy, the actual amount of money that is paid for their taxes may actually be less than 50 percent.

We have talked about—you asked me to cite, last Monday a couple of specific examples of things that we could do. I was pleased to read in your budget that you proposed to go after folks who owned rental incomes, to make sure that they are doing their fair share.

Just take a minute or two and talk to us, just very directly, about what this committee can do, on a consistent basis, to enable folks in the IRS to go out and collect the monies that are owed, at home and abroad, from the folks who owe it and who are dodging their responsibilities?

Secretary GEITHNER. Well, as you proposed and as you know, I think there is no solution to this that does not rely on better reporting and better enforcement capacity at the IRS, more carefully deployed. So a centerpiece of what we do in this area will have to have new proposals in this area. I am glad you pointed out the one provision in the budget we put in as a specific example of that stuff, but that is just a beginning.

Alongside these, as we said earlier, we are going to have to look at how to deal with the offshore shelter problem, and a range of other provisions in the tax code that make it quite easy to avoid U.S. taxes. So, we are going to try to bring a comprehensive set of proposals in that area, but I think you are right, that you have to start with reporting, and you are going to have to start with better, more carefully deployed enforcement resources. We are starting that process.

Senator CARPER. Good. I chair a subcommittee on the Homeland Security and Government Affairs Committee on financial management. We have held hearings, roundtables, to actually delve into this issue. Now that I am a member of this committee, I very much want to focus on it, as a matter of equity, and as we are looking for offsets. When we want to reduce taxes in some other area, we want to provide for spending in some other areas, we desperately need offsets, and I look forward to working very closely with you as a partner in this going forward.

Can we talk a little bit about carried interest, and talk about what the administration has in mind there? I certainly appreciate we have been talking about tax fairness, but I understand and appreciate the issue of tax fairness that comes into play, and also with respect to, especially, carried interest, given the need for greater long-term fiscal responsibility.

I also understand the need to generate additional revenues, which we have talked about here. But I feel that it is important for us to be smart about it and try to get it right. I am sure you believe that as well. We do not want to intentionally undermine business investment.

I think the proposed budget that you all have given us on this point is preliminary, but is it possible for you to flesh out some of the details of the carried interest proposal? Can you lay out the administration's thinking about how this proposal might work in practice? Do you think there is a case to be made for using more targeted efforts to differentiate between, say, the tax treatment for carried interest and from, say, private equity funds versus hedge funds?

Secretary GEITHNER. Senator, we will put out the details in the budget, but I just want to state the simple objective, as you did, which is to treat partnership income as ordinary income. We think, to be fair, you need to do that across all partnerships. It is, I think, very hard to make the case that you can differentiate fairly among different types, and that is why the provision is framed the way it is.

But obviously getting this right is important and, as with any issue, we would be happy to listen to any specific suggestions about how to do this well. But I think to do it, to make it fair, you need to treat partnership income as ordinary income, and you need to do so in a way where you are treating partnerships alike.

Senator CARPER. All right.

Last question. I met a week or so ago with David Marvin, a very smart guy from our State who used to run the DuPont Pension Plan. He now runs a firm called Marvin and Palmer, and they used to oversee investments, I think, of about $10 billion. Now they are down to about $5 billion because of the economy and the markets.

He suggested to us that we do a couple of things. One, he suggested to us that the SEC goes back and reinstates the uptick rule. He says it is a way to get after those who are literally, in some cases, acting as predators to drive down stocks. I think he, or someone else, also suggested to us that, in looking at the capital gains tax, that we actually try to incentivize people to hold stocks for a long period of time. In some cases, just take away their capital gains tax altogether if they hold it for 10 years or more, but for those who are churning the market, selling stocks on a daily basis and sometimes almost on a minute-to-minute basis, raising appreciably their capital gains tax. Any thoughts?

Secretary GEITHNER. I would like to think about the latter and get back to you. On the former, on the uptick rule, that is really an issue that Mary Schapiro, the SEC Commissioner, and her colleagues are looking at, and have been looking at. I will consult with her when I get back and ask her if she could lay out to you and your colleagues her thinking as she comes to this job and this issue fresh about how to do this, what benefits it might bring.

Senator CARPER. Thank you so much. And thank you for your service.

The CHAIRMAN. Thank you, Senator.

Senator Roberts, you are next.

Senator ROBERTS. Well, thank you, Mr. Chairman. And thank you, Mr. Secretary. You have given an extremely articulate, determined, and ambitious presentation. It has been very impressive. But this hearing sort of reminds me of the "Cool Hand Luke" movie. What we have here is a failure to communicate. And maybe it is me, maybe it is you. I do not think it is you. You have this down pat—pardon a terrible pun. [Laughter.]

But at any rate, I have three issues I want to ask you about. I call them ant hill issues. I am reminded of the time that I urged a colleague of mine not to stand where he was standing in giving a speech. He said, "I am fine where I am." I said, "No, you are not, you are standing on an ant hill with red ants." That is not a good thing.

We have three ant hill issues that folks out in the country, despite your very articulate views and very determined views, that they are raising. One, everybody knows that charitable organizations across the country are being asked to do more with less as donors tighten their belts, even without the tax changes, while more people are turning to charities for assistance.

Now, I have an analysis that found that, if the proposed tax changes in the budget were in effect in 2006, that the itemized contributions would have been reduced by almost $4 billion. That is $3.87 billion, to be totally accurate. In the Senate, we would round that off at $4 billion. But at any rate, that is not modest. That is a real problem.

The total value of charitable contributions that high-income households reported on their tax returns in 2006 was $81.26 billion. That is just not modest. I know it is not going to bring a halt to charitable contributions, I would agree with you on that, but it will reduce the contributions to charities at a time—the timing of this is so worrisome—when Americans are relying more on charitable assistance. I do not understand why the administration would try to create any disincentive that would reduce any donations to charities at this particular time. So, there is one ant hill that I want to go over with you.

By the way, there is a March 2009 study by Indiana University, just brought to my attention, that indicates 47 percent of higher income donors would give less if the deductions for charitable giving were eliminated.

The next ant hill question. I will try to make this—I am sorry, I am just going to make these observations, and then, if we have time, you can respond. I apologize for that. The proposal in the budget that reduces the ability for taxpayers to claim itemized deductions for mortgage interest. My goodness. What does limiting this tax incentive mean for individuals who have purchased a home within their means and who intend to live in it, or have lived in their home for a number of years, or for individuals who are looking to purchase a home right now? Should we not give them some certainty in the tax code with regard to the mortgage interest deduction? What does it mean for the value of their home? Is there not a concern that limiting the deduction would further depress home prices?

Now, I just do not understand that, and I would say that the budget does propose to reinstate the 36- to 39.6-percent income tax rates for individuals in regard to what has been referred to by Senator Hatch, and that is the third ant hill.

Basically, this is the situation where, in Kansas, we have over 60,000 small businesses which make up 97 percent of the State's employers. They are the leading job creators in the State, and this budget will raise their taxes.

Now, you say it is modest. I think that is the word that you use. But the National Federation of Independent Business, which Senator Hatch brought out, shows that 50 percent of the small business owners that employed between 20 and 249 workers would fall into these two top brackets. Over half the Nation's private sector workers are employed by small businesses with 20 to 500 employees.

So, at a time when we want to create and preserve jobs in the country, we should not be raising taxes on employers who are creating jobs, i.e., small business. I will tell you what is going to happen. This is the worry that I get back from my constituents and the small business folks. They worry that, in order to pay this additional tax burden, they may have to lay off workers, reduce wages or benefits, not hire new employees, pass these costs on to their customers. None of these are good options.

So I have demonstrated three issues that I would call ant hill issues. I know you have a very articulate response to this. I know that is part of the President's budget plan. I would urge you to get off the ant hills and find it somewhere else.

Secretary GEITHNER. Ant hills may understate——

The CHAIRMAN. Mr. Secretary, I will just give you a chance to address those three ant hills, briefly.

Secretary GEITHNER. All right. On the first two, what we are proposing is, as part of a fiscally responsible package to help bring about comprehensive tax reform, that in the context of comprehensive tax reform that we identify ways that will help finance this very important priority. That is something that we have to work with the Congress on. We know there are going to be different views on how best to achieve that objective. We have heard a lot of concerns about this specific provision. I understand the concerns around them. We will have to work through these.

But what we are not proposing to do is, now, in the midst of a recession, put in place these changes. We have put those out as proposals to help make credible our commitment to comprehensive tax reform. But it is something we are going to have to work with you on and find a way to do, that we are all going to be comfortable with.

I want to just make the same point on the small business side, just to emphasize. It is very important that, until we emerge from this recession, that we are keeping the overall burden of taxes on businesses across the country at current levels, and the budget does that. But it is also a critical imperative that, as we emerge from this, that we get back on a path to fiscal responsibility. That is going to be difficult to do, and we are going to have to do it in a way of shared sacrifice. The President's proposal is designed to make sure that those burdens come only on those at the various high end of the income spectrum, including in the business sector. But——

The CHAIRMAN. Senator Cornyn, you are next.

Senator CORNYN. I know for sure, Mr. Chairman, that Senator Ensign was here ahead of me, observing the early bird rule, but I will defer to the chairman.

The CHAIRMAN. All right. Senator Ensign. It looks like he feels like he should be recognized.

Senator CORNYN. Well, I will defer to him.

The CHAIRMAN. Senator Ensign?

Senator ROBERTS. No, he asked his questions. It is John's turn.

The CHAIRMAN. Between the two of you, whatever you want to do. You work it out.

Senator ENSIGN. Thank you, Mr. Chairman.

The CHAIRMAN. You are welcome.

Senator ENSIGN. I had to leave for about 15 minutes. I had another meeting.

The CHAIRMAN. Fine. Fine. Fine.

Senator ENSIGN. But I was here at the beginning.

The CHAIRMAN. Fine.

Senator ENSIGN. A couple of observations. First of all, all of the spending goes together, whether it is called TARP, stimulus, omnibus, the budget, or other spending coming up in the future.

I applaud you and the administration for holding a Fiscal Responsibility Summit last week. I think that is exactly what we need to be talking about. Our colleague, Evan Bayh, wrote an opinion-editorial this morning in the *Wall Street Journal.* I think he laid it out exactly right. We have to start thinking about spending as a whole. We have an omnibus bill that is in front of us today. This omnibus bill is not one-time spending. It is an 8-percent increase over last year, and it adds to the baseline. So it is not just the $20-billion increase over last year. When you compound that over 10 years, it is hundreds of billions of dollars.

You mentioned in your opening statement that this administration was making tough choices. What I do not understand is why you would not have stood up and said to the Congress, "All right, yes, this may be last year's work, but times have changed. The economy has changed. We need to start making tough choices." Every family in America is making those kind of choices right now. They are asking themselves, what can we afford, what can we not afford?

Every business in America is saying, where are we wasting money? Where do we need to get tighter? We are not requiring that of anybody in the government at the Federal level. My question for you is, why did you not show leadership at this time? We would have joined you in a bipartisan manner and said, "You know what, let us be fiscally responsible right now."

Secretary GEITHNER. Senator, I am nodding because you are making a fair point. But I want to point out that, in the 2010 budget, the President does identify some very substantial immediate cuts in programs that we do not think the American people should support anymore, that we do not think are effective.

Senator ENSIGN. On the discretionary side?

Secretary GEITHNER. Yes.

Senator ENSIGN. What are they, and what are the amounts?

Secretary GEITHNER. Well, one example is to eliminate the subsidies to middlemen in the student loan market. One example is around overpayment for managed-care providers in Medicare. There are other examples in there, smaller ones and larger ones.

Senator ENSIGN. Well, that is not discretionary, but that is all right.

Secretary GEITHNER. Yes, that is a fair point. But again, in the budget—I just want to emphasize this. In the budget, the President proposes to bring non-defense discretionary expenditures down to a lower share of GDP than we have seen over a long period of time. And, very importantly——

Senator ENSIGN. That is if GDP grows.

Secretary GEITHNER. Well, that is true. But you need to measure all these things against the size of the economy and the projections in the President's budget over the 5- to 10-year period.

Senator ENSIGN. If the projections are correct?

Secretary GEITHNER. True. But the long-term projections in there are an economy that is growing at a sustainable rate. There is no difference between CBO, OMB, and the private forecasters on what that long-term rate is. Another thing that is very important, again.

Senator ENSIGN. Except that CBO and OMB are always wrong.

Secretary GEITHNER. Well, forecasts are never what they are. But over time, the economy does tend to return to its potential growth rates. But that is the forecast that underpins this.

But I just want to associate myself with your basic conviction that we are going to have to get ourselves back on a path to sustainability, and we have to demonstrate to people we are willing to do stuff that is hard and difficult. A test of that today is how much opposition you have seen to the specific proposals we have put on the table. I just emphasize that because it is not going to be easy to do. It is going to——

Senator ENSIGN. I only have a minute left. I want to get one more question and comment in. I just wish you would have taken this opportunity to cut spending, and you wasted that opportunity.

There was an earlier question that Senator Enzi had on jobs created versus saved. I just wanted to follow up with that. You have created a situation where you cannot be wrong. If the economy loses 2 million jobs over the next few years, you can say, "Yes, but it would have lost 5.5 million jobs." If the economy gains a million jobs, you can say, "Well, it would have lost 2.5 million jobs."

When you use the terms "created" or "saved," you have given yourself complete protection where you cannot be wrong, because you can take any scenario and make yourself look correct on created or saved. That is why we are looking for a metric on the created side. It is easy to say "I saved" if we only lose 2 million jobs.

Secretary GEITHNER. Mr. Chairman, just very quickly. The President lays out in the budget an expected path for the economy over time that builds in an expectation for what impact we think the

Recovery Act will have. The economy may perform better than that or worse than that, but you will be able to use that as a way to measure what the full force of American economic policy does over this period of time.

Now, things will——

Senator ENSIGN. So we will be able to hold you to those numbers? If you do not meet those projections——

Secretary GEITHNER. No. I am just saying that—I am just saying that——

Senator Ensign [continuing]. On GDP, then your stimulus package will have failed?

Secretary GEITHNER. No. You can measure the success of the policies we put together—design and implement, because we have to do it together—on what happens to growth in unemployment relative to what people thought would have happened in the absence of these policies.

Now, what are we trying to do? We are trying to, again, reduce the risk that the economy shrinks by more than it needs to, that unemployment rises by more than it needs to, that more businesses fail than need to do. We are trying to arrest the recession and prevent a deeper recession that will cause much more damage to the fortunes of Americans. That is the obligation we all share, and that is what these proposals are designed to do.

The CHAIRMAN. Senator Cornyn?

Senator ENSIGN. Thank you.

Senator CORNYN. Thank you, Mr. Chairman.

Secretary Geithner, let me ask you about two topics in the short time we have together. I am concerned, in the proposed budget, about the Nation's oil and gas industry, and more specifically, I am concerned about what the policies laid out in the budget would do to increase our dependence on imported energy at a time when I think the country is of the mood that we need to find more here at home and use less as we pursue alternative energy sources.

But can you explain to me how the President's proposal for a new excise tax on offshore oil and gas production in the Gulf of Mexico will actually encourage more domestic production as opposed to the opposite?

Secretary GEITHNER. Senator, as you know, and I think it is clear in the proposal, we do not believe it makes sense to significantly subsidize the production and use of sources of energy that are dramatically going to add to our climate change imperative. We do not think that is good economic policy, and we think changing those incentives is good for the country. You should view these provisions through that basic prism. Now people will not necessarily agree with that objective, but I think that is an important objective.

Now, again, just to do proportionality, the impact of these subsidies is very small relative to revenues produced by U.S. oil and gas producers. I think you make a reasonable case that this impact can be absorbed. But as I said, the overall objective is not to be providing ongoing subsidies to forms of energy production that are going to add to this critical long-term imperative of climate change.

Senator CORNYN. Do you understand that raising taxes on small and independent energy companies/producers here who develop 90 percent of U.S. oil and gas, natural gas, will actually hurt job creation in that sector of the economy as opposed to help it, which I thought is what we were about?

Secretary GEITHNER. Senator, what I know for sure is that we start with a deeply unsustainable fiscal position and a deep and deepening recession. We have to move forcefully to fix that set of problems. That is going to require very tough choices about how to get us back on a fiscally sustainable path. It is going to require some shared sacrifice and burden across the American economy.

We are not going to be able, given where we started from, to get us back to a sustainable fiscal position without doing things that are going to be hard. I think this is a reasonable policy, given the overall objective of, again, making sure we are not providing artificial incentives to produce and use energy that is going to make our broader climate change imperatives worse.

Senator CORNYN. I understand your answer. My view is that higher taxes on small and independent producers here in America will make us more dependent on imported oil and gas while we transition to cleaner energy alternatives, a goal we all share. It will also hurt job retention and job creation in the energy sector, which provides an awful lot of jobs in this country.

Let me just ask, in the short time we have remaining—I applaud the President's stated goal to reduce the budget deficit by 50 percent by the end of his first term, but I am mystified why the administration would not tackle what is a bigger problem, and that is the unfunded liabilities of the Federal Government because of entitlement spending, some $67 trillion. The way I read the proposed budget, this budget would actually make entitlement spending worse rather than better because it adds additional mandatory spending of $357 billion.

Can you explain the rationale to me?

Secretary GEITHNER. Senator, the President shares your commitment to long-term entitlement reform because that is essential to put us on a path to fiscal sustainability. The most important thing we can do in the near term to get us on that path is to reduce the rate of growth in health care expenditures. That is the principal source of increases in these long-term entitlement costs. It is not the only source, but it is the principal source.

There is no path to addressing those things without starting with, and going through, health care reform that reduces cost growth. But as you know from what he said in public and what we began last week, there are other things we are going to have to do, working with the Congress. We are trying to begin a process of building consensus on how to get to the point where we are taking on those other challenges that are not going to be addressed simply by reforming health care. Health care, you have to start with, though.

Senator CORNYN. Outside of reforming health care, a goal which we all share, does the administration have any other proposals to deal with these unfunded liabilities, $67 trillion?

Secretary GEITHNER. Well, Senator, as you saw in the agenda for the Fiscal Summit, there are a comprehensive set of other areas for policy where we need to begin a process of figuring out how to solve those. But we have to start somewhere.

Senator CORNYN. And lastly, specifically, you have no proposal to deal with the impending insolvency of Social Security in this budget.

Secretary GEITHNER. Senator, the budget does not propose a specific set of reforms to Social Security, but you are right to say this is very important for us to do. We would like to begin the process of working with the Congress on how to figure out how to put Social Security on a path to long-term viability. It is a very important thing to do. As I said, health care is necessary, but it is not sufficient for addressing these long-term entitlement problems. You are right to——

The CHAIRMAN. Senator Menendez, you are next.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Secretary, thank you for your service. On page 2 of your testimony, you talked about how both our economic and financial problems are being compounded by problems in the housing market, with 2.5 million foreclosures, the $2.8-trillion lost in real estate wealth. For the average American, this is the single-biggest asset that they have and that they draw upon for a variety of reasons: educating their kids, dealing with a medical emergency, retirement future.

I have listened to a wide range of individuals in the housing universe from all different dimensions, and they come down on, it seems to me, pretty much two universal things. One is, continue to drive the rate down even further—and it is pretty low right now—and second, extend the home ownership credit beyond new home ownership to all.

What do you think of those proposals? If you do not like those, how do we see stopping the collapse of the floor here on the housing market? Because it seems to me that that is pretty critical for us to move forward in this economy.

Secretary GEITHNER. I think you are absolutely right that, although mortgage rates are lower, the spreads between mortgage rates and treasuries are still at, in some areas, abnormally high levels. We would like to continue to find ways to bring those spreads down. That would be very beneficial to the broad objective we share.

On the tax side, I need to think about that a little more carefully. I do want to point out that we are moving very quickly to make sure that the tax credit that was in the stimulus package is made operational. We announced last week the details, importantly, that people can take advantage of that tax credit against their 2008 income, which will make it have more power more quickly. But I am happy to think through and take a look at additional things we might be able to do on the tax side. It will be hard to do, I think, but I am willing to look at that.

I do think the program the President announced will help, and not just on the interest rate side, but on the refinancing side. It will help by helping people who can stay in their homes take advantage of more——

Senator MENENDEZ. Those undoubtedly are worthy.

Secretary GEITHNER. Yes.

Senator MENENDEZ. I support them and have voted for them as well. The question is, how do we stop the free fall of the marketplace and values in homes, which, if it continues—now, keeping people in their homes is great, making sure they can refinance is great, but I think we need to do something more, and we look forward to working with you on that.

Secretary GEITHNER. I do think it is very important for people to understand that the most important thing you can do for the housing market is to make sure that people do not lose their jobs. The most important way to do that is to try to make sure this economy gets back on track. That is what the Recovery Act is designed to do.

Senator MENENDEZ. Senator Carper asked you about carried interest. I just want to ask one quick question. My understanding is, the proposal in the President's budget not only includes hedge fund managers and others, but all who, in essence, use the provisions of carried interest are going to be treated equally, in the same way.

Secretary GEITHNER. That is our proposal.

Senator MENENDEZ. If, in fact, it gets passed. All right.

And then, finally, you—and the chairman has worked mightily on this. But in your testimony on page 6, you talk about the President advancing a series of legislative and enforcement measures to reduce U.S. tax evasion and avoidance. You talk about proposed rules to both reform U.S. corporations' ability to defer foreign earnings and deter high-income individuals from using tax havens to avoid taxation.

Last December, Chairman Baucus released a discussion draft of proposed legislation to put reasonable limits on the use of excessive offshore related-party reinsurance by foreign property and casualty insurers that gives them a competitive tax advantage over those who stay here domestically and do not do that.

The chairman's proposal seems to me to be consistent with the administration's strong stance against offshore avoidance. Is this something that the administration supports?

Secretary GEITHNER. It is something we are going to take a careful look at. It looks like a very positive step to us, but I will look more carefully at it in the context of the proposals we are going to bring forward on the broader international tax avoidance plan.

Senator MENENDEZ. Well, I look forward to working with the chairman, and with you. It just seems to me that at the end of the day we want the average taxpayer to pay their fair share.

Secretary GEITHNER. We do.

Senator MENENDEZ. It seems to me that those who game the system not to pay their fair share and create a domestic disproportionate set of circumstances for those who do make their investments here in the United States and follow the law within the context here in the United States, are at a competitive disadvantage, and we need to end that.

Thank you, Mr. Chairman.

Secretary GEITHNER. I think it is necessary for fairness, and it is necessary for fiscal responsibility.

The CHAIRMAN. Thank you, Senator.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman.

Thank you, Secretary Geithner. I am certainly pleased you could be here today to discuss the administration's budget outline. I think it is very important to reiterate the point that the budget really is a vision, or a blueprint, of how we plan to move the Nation forward. I think it expresses values and goals, and hopefully lays out a path forward towards a better tomorrow. Quite frankly, all of us as Americans, that is what we are striving for, a better tomorrow.

I have so many questions and comments, and so little time. I would like to applaud the administration, your statement here, wanting to tackle health care reform, a new energy economy, making additional investments in education, all of which we know are investments that pay dividends down the road.

But there is no doubt that we are in the here and now right now in what we are dealing with. Those of us who talk to our constituents on a daily basis hear from them the concerns that they express about—going back to this past fall, just as Senator Snowe mentioned—the government has made huge investments—huge investments—of taxpayers' dollars. Our government came to us, the administration came to us: the sky is falling. We have to act now. We have to act now.

We are still hearing a lot of that, and yet we are not seeing the results of what we were asked to do when the sky was falling this fall. So I would just associate myself with my colleague from Maine, Senator Snowe, that there has to be greater explanation. It cannot just be posting who got money.

We need to know where that money is going and where those resources are happening, because I am having daily calls from my constituency, who cannot access those dollars and who are desperate to create jobs and to keep their good businesses. Most of these people are people who have acted in a fiscally conservative way, who have investments and own their businesses outright and want to continue with operating loans that will keep them making payroll. I say, the sooner that you can get more of that information out there, it is enormously helpful on the other end of the line, which is the confidence end. We have to create confidence that what we are doing here has tremendous effects and will bring about tremendous effects.

But we have steep costs out there. They are leaving us massive, massive deficits, Federal deficits and debt levels. I am concerned about that long-term debt, and I am concerned about how the outline for your budget gets us to deficit reduction in the mid-point, but in the out-years we continue to see that debt rise. I think that is a concern.

Back to what Senator Cornyn brought up, talking about health care costs. I believe that through health care reform we will help deal with some of the costs, long-term costs, that exist out there. Did you account for that in the revenue modeling?

Secretary GEITHNER. Well, in the revenue provisions of the budget we included these new proposals for helping to fund part of the cost of long-term health reform. Am I answering your question? I am not sure I am answering your question.

Senator LINCOLN. Well, somewhat.

Secretary GEITHNER. So where we propose revenues to help finance health care reform, we did put those in the budget.

Senator LINCOLN. All right.

The other question I would ask would be similar to what Senator Snowe asked, and that is, why were your projections so much more optimistic with the GDP projections that you had?

Secretary GEITHNER. Some of those projections you are comparing against—OMB's, CBO's—were done before stimulus.

Senator LINCOLN. Right.

Secretary GEITHNER. So that accounts for some of the difference.

Senator LINCOLN. So you are counting the stimulus in your predictions here.

Secretary GEITHNER. Yes. As every economist ultimately will. But the CBO's new estimates that are done post-Recovery Act have a low and a high end estimated forecast. The administration's forecast is within that estimate.

Senator LINCOLN. Why did you include continued war spending at 2008 levels, adjusted for inflation? I mean, surely you know the administration has a plan of what they are going to be doing and an idea of what they are going to spend on the war based on what we heard in the campaign. I mean, I am just curious to know why you did that. That is a lot of spending.

Secretary GEITHNER. Senator, what matters is what we spend. As you know, the President has made proposals to alter strategy in Iraq and Afghanistan, and the budget accounts for an initial estimate of what that is going to do to spending going forward. That is the critically important thing. In the budget, we had to start somewhere. They started with a spending level that we inherited from this administration with their strategy for those wars.

Senator LINCOLN. It just seems a little phantom to me in terms of gimmicks and how you might do that.

The last two things I would just like to bring up, Mr. Secretary. Senator Roberts and I have both been very concerned about the impact this economic crisis is having on individual retirement savings. It is enormous. Just in talking to my constituents, it is phenomenal, the pain they feel, the fear. We had a woman testify in the Aging Committee just last week, in tears, about what has happened to her savings, to her husband's, and what they are up against. So I think that is a critical issue and am just hoping that we will see some steps here to address some of those concerns.

In the past several years, the past 8 years, the budget that we get up here always puts a disproportionate burden on rural America. I am saddened to say that I am not so sure that this budget is any different. Rural America is a different place, it is a different animal, and most of what we do here has a disproportionately negative effect on rural America.

These people are hurting just as bad, if not more, because they are usually the first to see the downturn of an economy and they are the last to see the upswing. I am not so sure some of them have not come out of that last downturn. So, I certainly would appreciate you all taking a look at some of the disproportionate burdens you are placing on rural America in your budget.

Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman.

Thank you, Mr. Secretary. These are not easy times, and I think we all appreciate your efforts.

I would like to talk a little bit about small business. Not about the tax rate, but the—we talked about this a little on the phone. I am finding, in the last month, something that is really scary to me. That is, profitable small businesses are having their lines of credit pulled by banks.

One little story. I interviewed someone for a job. His father owns a heating oil company, about 50 people, I think 8 trucks, in southwestern Connecticut. Profitable business. He gets a $4-million line of credit from the bank at the beginning of the month to pay for the oil, and he pays it back. Never missed a payment. The business is about as profitable as it has always been. The bank has pulled the loan, pulled the line of credit, and he cannot find another one. That business is about to go under.

We have a hardware company in northern New York, exactly the same thing. They say, well, the value of the inventory is lower. They are pulling the line of credit. This is a business that started in 1830. It employs 300 people. We have problems, again: Hickey Freeman, 800 jobs in Rochester. They are not as profitable as they were. People are not buying those suits. Nonetheless, it is a good, ongoing business.

My great worry here is if banks are pulling—when we heard banks are not lending, we assume nothing new is going to get started. But if they are starting to pull lines of credit from profitable small- and medium-sized businesses, the unemployment numbers are going to skyrocket, and everything we have done in the stimulus and in this budget will be undone. Can you give us some idea of what the administration is planning to do about this? It is a deadly problem, I would say.

Secretary GEITHNER. Sir, you are exactly right. It really is happening across the country.

Senator SCHUMER. And I think more in the last few months than before. Is that——

Secretary GEITHNER. Well, the recession is deepening, and these things feed on themselves.

Senator SCHUMER. All right.

Secretary GEITHNER. That is why they are so dangerous, so important to arrest. You are absolutely right, and all of your colleagues are eloquent in saying it, which is, financial crises and recessions are brutal and tragic and unfair, because the damage is indiscriminate and people who were perfectly responsible get damaged by the actions of those who were irresponsible.

Senator SCHUMER. Right. Right.

Secretary GEITHNER. The necessary thing to do, apart from making sure the Recovery Act stuff takes effect quickly——

Senator SCHUMER. Yes.

Secretary GEITHNER [continuing]. Is to make sure that banks have enough capital they can lend and that we are providing very substantial support to get these credit markets to open up, which is what we are doing.

Now, community banks need to get access to capital more quickly under the existing programs. The stimulus package includes a very important expansion of the small business lending program and the guarantee fee.

Senator SCHUMER. Will the TALF work in this regard?

Secretary GEITHNER. The TALF, this direct lending program I referred to, we believe will be very helpful in trying to help get that small business going again. There are other things we would like to try to do, working with you and your colleagues. There are many ideas in this committee and up here on the Hill that we would like to reflect on. But the necessary thing is to make sure that banks have the resources and the ability to lend, and many do. Some will need a little temporary assistance as a bridge to private capital. It is very important that we move to make sure those resources are available.

Senator SCHUMER. Mr. Secretary, banks are pulling back. Even with some of these banks—I do not want to give any names—there are some who have received the capital infusion, some have not.

Secretary GEITHNER. Right.

Senator SCHUMER. But worse, these business people, small- and medium-sized, search for other sources of lending, and no one is making them a loan.

Secretary GEITHNER. Right. Well, again, there are banks across the country that were careful and prudent and are able to expand now because they have substantial buffers of capital. Many banks are being more defensive because they are so worried about the impact of the recession. This is why it is so important that we make sure that there is capital available where it needs to be, and that we go to banks through programs like the TALF to try to get markets flowing again.

Senator SCHUMER. Right.

Secretary GEITHNER. We will do that on a scale sufficient——

Senator SCHUMER. When will the TALF program be set up for small businesses so they will feel their loan is guaranteed and they can continue this line of credit or issue a new line of credit to a new company?

Secretary GEITHNER. The TALF program. We announced the detailed schedule of funding yesterday.

Senator SCHUMER. Right.

Secretary GEITHNER. And you are going to see it, within the next few weeks, up and running, and you will start to see funding available for new loans, and that will help. But the really important thing I want you to understand is, we are going to keep at this. It is going to require more things, but you are absolutely right to underscore the importance of this to help get recovery back on track.

Senator SCHUMER. This will raise the unemployment rate and send the economy down. When it is profitable businesses that are going under because they cannot get credit, it is scary.

Secretary GEITHNER. Right. It is scary. It underscores, again, why credit is so important to recovery. In our system, banks play a critical role in that, not just the credit markets. You have to move on both together.

Senator SCHUMER. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Mr. Geithner, I have a question about Federal Aviation taxes. As undoubtedly you know, we in the Congress attempted to pass reauthorization of the Aviation Trust Fund. This committee had jurisdiction over the revenue part of it, the Commerce Committee, their part. It went to the floor, and it was not passed because of offsets for highway funds, totally unrelated to airport issues.

Now, this administration's budget, as I understand it, proposes replacing the ticket tax revenue with some sort of user fee scheme. I would like to tell you that that is not a good idea. I strongly encourage you to go back and just use the process that has worked before. It is true, the current funding expires in March of this year, so we have to pass some kind of a short-term extension.

But the administration prides itself on honesty in budgeting. I think what it is basically trying to do is to convert the classification, the category of revenue, from taxes to fees, and therefore avoid putting it in the budget. But still, it is going to be a cost imposed on people, and I just strongly urge you to work with this committee and the Commerce Committee. We put together a bill last year to address the reauthorization of the Airport Trust Fund.

Secretary GEITHNER. Well, Senator, we will take a careful look at it. I do not think that was the motivation, but we will take a careful look at how to do this.

The CHAIRMAN. Well, if that was not the motivation, what was?

Secretary GEITHNER. Maybe I should come back to you with a more thoughtful case so we have a chance to understand your concerns and why you think there is a better approach for doing it, but we will work with you.

The CHAIRMAN. Yes. Because I am just telling you, I do not think it is a good idea, what you are trying to do here.

Secretary GEITHNER. I hear you.

The CHAIRMAN. I was struck with the comment that somebody—I think it was some authority—made. It is a little bit different take on the financial credit problems. It was this. If I have my data and if I remember correctly, household debt as a percent of Gross Domestic Product is roughly 30 percent, 40 percent for a long time. It started to creep up a little bit in maybe the 1990s. In the 2000s, particularly in the last couple, 3 years, it has shot way up. The figure I recall is 100 percent of GDP. The last time that household debt was that high was 1929. This person's thought was, sure, part of the problem is that banks are not lending, but part of the problem is that they are lending too much.

Secretary GEITHNER. They were lending too much.

The CHAIRMAN. And that is credit cards, home equity loans, or whatnot. Homes, in the first place. Household debt. I do not think a mortgage is included in household debt. But if you could just address that observation.

Secretary GEITHNER. Right. Well, I think, as I tried to say earlier, you are absolutely right that this is a crisis born of a period of sustained over-borrowing by households, but also some parts of the rest of the economy, and by governments. That is true around the world. What that means is, there is a necessary adjustment process we have to go through, and that will reduce and lower levels of borrowing for a sustained period of time.

What we need to be worried about, though, is the risk that, as economists say, it overshoots and you see a greater reduction in lending than is necessary for that process of adjustment to take place. That is something we need to arrest and prevent. But you are right to point out that part of what we are going through is a necessary process of adjustment after a long period where people were borrowing beyond their means. That will make this recession deeper and more traumatic than it otherwise would have been.

The CHAIRMAN. Some things just do not change. I think Benjamin Franklin said, "He who goes a'borrowing goes a'sorrowing." We just borrowed, all of us, way too much and now we are paying for it.

Another question that Senator Cantwell somewhat touched on, and I think a couple other Senators have, too. I think one reason that confidence is not restored—there are tons of reasons, but one is because people just do not understand TARP and TALF and all these different toxic assets, and purchase, and repurchase, and so on and so forth. They just do not understand it.

When you try to explain it, when Chairman Bernanke tries to explain it, when members of Congress try to explain it, it is just Greek. It is another language. It just is not understandable. I wonder, is there some way you can kind of just explain, in English, so the average American can understand? I think most members of this Congress do not understand it.

Secretary GEITHNER. I completely agree. I think the instruments are complicated, but the objective is relatively simple. The objective is to try to make sure that banks are strong enough that they can lend and provide credit and we get these pipes that are critical to the credit markets unfrozen and unclogged.

The CHAIRMAN. Well, I just urge you to try to think this through, and more in words and terms so the average American starts to understand. I do not want to overstate this point, but I happened to be listening to NPR, American Experience, or American something, about a week or two ago, trying to explain all of this in simple terms. They started a little balance sheet. This guy has $10 and loaned to somebody who had a doll house, and so on, and they just got it more and more and more, and I thought it was very well done.

Secretary GEITHNER. Yes. I thought they did a very nice job. I agree with you.

The CHAIRMAN. Yes. If somehow you can just talk about this in more basic, sort of simple terms and put it in terms that the average American household relates to, that might help quite a bit, for whatever it is worth.

Senator Grassley?

Senator GRASSLEY. Yes. I have a couple of questions, but before I do that I would like to call your attention to something you probably would not know about, to check on it. I sent you a letter a few days ago, seeking some information. I have a follow-up letter that you are going to receive today, and it deals with private debt collection contracts and programs that we have. I need some information on that. I appreciate that.

There are a number of things that I would like to talk to you about: itemized deductions, Pease limitation, the related concept of

PEP, 28 percent limitations, basically what I would consider a hidden tax rate, and to find out—well, let me see if I can shorten this up.

Basically, we are interested in the fact that, as I stated in my opening statement, I consider this a 2-, 3-, or maybe in some instances, 4-percent increase in the tax rate above 39.6 or above 36. The purpose of it, I think, is to be a hidden marginal tax rate, so it does not look so bad.

So my preference would be to completely eliminate PEP and Pease without any offsetting tax rate increase. The next best option for me would be to have PEP and Pease eliminated with an offsetting tax rate increase, and the worst option would be to have it back in full force in 2011. So given the President's stated laudable commitment to transparent budgeting, I would think that the administration would not desire a return to what we call PEP and Pease.

So my question: is the administration committed to having PEP and Pease returned in 2011 or would it instead be willing to have PEP and Pease completely eliminated in exchange for a higher tax rate?

Secretary GEITHNER. Senator, I would like to spend a little time on this issue. I would like to take a careful look at that. I think you are right. We need to give you a clear assessment of the combined impact of these changes. I will come back to you with a more thoughtful view on how we could address your concerns.

Senator GRASSLEY. Well, if there is an intellectual basis for it, I sure do not see it. I think it is just simply because somebody did not want to cost 40 percent when we had the 1990 tax bill, I think it was.

I want to ask you about another consequence of the President's proposals to fully reinstate—again, back to the Pease limitation—and to limit itemized deductions to 28 percent for single filers and families above $250,000. The most recent IRS data available, tax year 2006, shows 3.2 million filers with adjusted gross incomes of $200,000 or more claimed the deduction for State and local income taxes on their itemized returns. The amount of these 3.2 million deductions was $121 billion, or nearly $38,000 per return. In my State, 22,000 people were affected by it; in New York State, 313,000 were affected by it.

If the proposals in the President's budget to limit itemized deductions to 28 percent for higher-income filers are adopted, does this not amount to a tax hike on State and local income taxes for more than these 22,000 in Iowa and the 300,000 in New York, that I used as examples? That is question number one.

But put another way, if the Federal tax benefit of the State and local income tax deduction is cut back, is the net effect to the taxpayers not higher State and local taxes? Would that not be contrary to what we are trying to accomplish by giving the States so much aid so they do not have to raise taxes?

Secretary GEITHNER. Yes. Senator, I understand this concern, but I would just come back to the context. Again, what we did is, as part of a proposal to lay the foundation for comprehensive tax reform, we identified a series of ways we could help pay for this and do it in a fiscally responsible way. But that is a process we are going to have to have with you and your colleagues. There are going to be different views on how we can meet those broad objectives. Of course, we are going to be open to working through this in a way that meets these broad objectives.

But the context is, again, as part of an effort to build consensus on comprehensive tax reform, we wanted to identify ways to do this that we could in a way that would make it fiscally responsible. But I understand those concerns, and we will work with you on how best to address those.

Senator GRASSLEY. All right.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Enzi, you are next.

Senator ENZI. Thank you, Mr. Chairman.

A person in Montana had a proposal that was passed on to small businessmen in Wyoming who talked to me about it, and it was a way to take care of small businessmen in this retracting market for loans and things. What he was suggesting was, for each employee that a small business employs, that they receive a $20,000 unsecured loan directly from the Federal Government, at low interest.

Now, I asked some questions about that, because that could amount to a whole lot. But fitting in with your "save" or "create," they suggested that we ought to talk about "rehire" or "create," and "rehiring" being that "saved jobs" number.

They were not particularly tied to $20,000, it was just a good idea that they had. But it would stimulate loans in direct relation to something that was achieved. So, I just hope you will put that down as a possibility. I am not asking a question, just mentioning that, because I thought there was some validity there and a lot of flexibility, but maybe some kind of a solution for small business.

Returning to the budget, Mr. Secretary, the President's budget request asks for $750 billion for financial stabilization, but plans to lose, apparently, $250 billion. I would like to know how you arrived at that number. Is the 33-percent loss Treasury's investment strategy for this money?

Secretary GEITHNER. Senator, thank you for raising it. Absolutely not. The estimate in the budget reflects the OMB/CBO judgment on how to score the potential risk of the subsidy costs associated with investments in the financial sector. That is the ratio I believe they used for the TARP legislation that was passed by the Congress last year, and that is the basic framework for it. But that is, of course, not our investment strategy. It is just an estimate of the potential subsidy cost in a program of that magnitude.

I want to underscore just a point, though. This is not a request to the Congress. It is not an estimate of the potential future cost. It is just a recognition of reality, that it is possible that we are going to need to do this with more resources, and so we wanted to put in the budget—in an abundance of caution like we do for other types of expenditures, wars and natural disasters—a place holder.

Senator ENZI. Well, why would you not put the whole $750 billion in there though instead of just the amount of loss that is anticipated?

Secretary GEITHNER. Well, only because what matters in the budgetary context is that, again, under the established procedures by CBO, what matters is the estimated subsidy costs associated with those types of investments. So we are doing what I think is conventional, good budget accounting.

Senator ENZI. So, if it is just a placeholder, as a reserve until it is needed, who is going to make the determination about when the money is needed and, if and when it is needed, why can you not just come back to the committee and the Congress and ask for it at that point?

Secretary GEITHNER. That is what we will do. But we were laying out as realistic a budget as we could, consistent with the range of other changes we made to how we think about natural disasters and wars. We thought, to be consistent in that context, it was better to acknowledge the reality that it is possible we need to come back to the Congress for more resources. But this is not a request. If we reach that judgment, we will come to you with a request. We will explain to you why we think it is necessary, how much it will cost, and give you the opportunity to reflect on whether that is in the interests of the country.

Senator ENZI. I am glad to hear that, because the last time the Department of Treasury asked for a blank check it was provided to them, and the results, I think, were disastrous as far as what we thought it was going to go to. With all of the questions we have had on AIG, I think that is true, not just speculation. So I am really pleased at your assurance that you will be coming back and have something very specific for us in the way of a plan with that.

Thank you, Mr. Chairman.

Secretary GEITHNER. Mr. Chairman, I misspoke in answering Senator Grassley's last question in using the words "comprehensive tax reform" rather than "health care reform" twice. What I wanted to say was, these proposals to change deductibility, we put on the table in the context of a proposal to begin a discussion on comprehensive health care reform, and it was in that spirit that we identified ways to do that in a way that was fiscally responsible. I just misspoke about comprehensive tax reform.

The CHAIRMAN. I appreciate that.

Secretary GEITHNER. Although we are interested in tax reform, too.

The CHAIRMAN. I appreciate that Freudian slip. [Laughter.] I am sure you are thinking about tax reform. All right.

Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman.

I would like to go back to the deductibility question. I was curious, Secretary Geithner. How was the threshold of $250,000 arrived at?

Secretary GEITHNER. You mean, in the President's broad tax proposals?

Senator CANTWELL. Yes.

Secretary GEITHNER. Well, he laid out a set of proposals in the campaign. It is very clear to the American people that he thought, as we move forward and make investments that are critical to our long-term future, that we are going to need to bring more fairness and balance to the tax code, and that would require letting those tax cuts on Americans earning more than $250,000 expire and restoring those marginal tax rates to the level they were in 2001. So what he is doing in the budget is——

Senator CANTWELL. So it was just taken from the campaign? I mean, there is——

Secretary GEITHNER. It is a commitment that he made to the American people in the campaign.

Senator CANTWELL. And what do you think, given the limitation on deductions, the tax rate might actually be on those families?

Secretary GEITHNER. Well, the proposals on deductibility change the tax treatment of a set of deductions. What they do is restore the level of deductibility for charitable contributions and other things to the level that prevailed at the end of the Reagan administration. It was still a level roughly double what the typical American gets in that context. Again, we think that is fair and reasonable. But we made these proposals only in the context of trying to begin a broad conversation on how to bring about comprehensive health care reform.

Senator CANTWELL. Well, I mean, these policies that we have, whether it is deductibility for mortgages, or my colleague brought up local taxes, like sales taxes or charitable contributions. These are all things in the code. It seems to me if we want to debate whether we give those deductions in the code, it would be a better way to decide what to do as opposed to putting an arbitrary cap basically at 28 percent on all itemized deductions.

Secretary GEITHNER. Well, again, we are restoring the level of deductibility to a point that has been achieved in the past because we are trying to identify ways to achieve health care reform in a way that is fiscally responsible. So, it is in that context that we are proposing this.

Now, of course we are going to have a debate on this, and we should have a debate on it. As many of your colleagues have said, many people would like to do this without going beyond the health care system itself. But we will have to work through this with you.

Senator CANTWELL. Well, we certainly want to work with you. I think the committee will, if you can see from the questions that people had on this. Not all States are alike, and this will have a different impact. I would ask you to look at that, what you think for those families, particularly in a State where deductibility of sales tax, itemization of sales tax, is a big issue, what the rate actually might end up being on these families, because I think it might be higher than you are anticipating.

Secretary GEITHNER. A fair question. We will provide a full range of analysis to that impact as we go through this process.

Senator CANTWELL. Thank you.

I thank the chair.

The CHAIRMAN. Thank you, Senator.

I have a couple of questions here, and I think Senator Grassley has one.

When people talk about the debt, what is the difference between publicly held debt and total debt? Is the concept of debt held by the public, publicly held debt, irrelevant in terms of markets and so forth?

Secretary GEITHNER. Yes. The economically relevant measure is the next debt held by the public, of the general government.

The CHAIRMAN. So when people talk about total debt, what is the relevance of that to markets or to the economy?

Secretary GEITHNER. It should not be relevant. Really, the right economically relevant measure is the net debt outstanding held by the public. That is the level that affects whether you are crowding out prior to investment and whether interest rates are going to be higher, or whether they will be lower. But by that measure alone, because of where we are starting from, that is on a rising path, and we have to stabilize it.

The CHAIRMAN. Right. Right.

It is my understanding that the budget deficits, as a percent of GDP, are roughly constant, around 3.2 percent, something like that, 3 percent, roughly.

Secretary GEITHNER. Right. The level of deficit that stabilizes the debt-to-GDP ratio is roughly in the range of 3.

The CHAIRMAN. Right.

Secretary GEITHNER. Ideally it would be a little below 3, but roughly in that range. That is driven by the rate at which you think the economy may be able to go sustainably over time and what level of interest rates prevail over time.

The CHAIRMAN. Maybe you answered this already. What is an acceptable sustainable rate, that is, deficits as a percent of GDP, generally? Was there a goal you were striving toward?

Secretary GEITHNER. Well, 3 percent is that—do you mean the level of debt outstanding to GDP or the level of——

The CHAIRMAN. No, no.

Secretary GEITHNER. Three percent is the level that is consistent with this definition of sustainability, which again is the level which stabilizes the debt-to-GDP ratio, the level of debt relative to the overall income produced by the economy in a given year.

The CHAIRMAN. All right.

Now, let us look at debt for a moment. Right now, I think it is around, roughly, 38 to 40 percent as a percent of GDP. Then I think it increases up to close to 67 percent in a year or two. Then that is flat, that level.

Secretary GEITHNER. That is right. That is right.

The CHAIRMAN. This raises the question, what is a proper level of debt-to-GDP? When do you start getting nervous?

Secretary GEITHNER. I would say, most economists believe that is a manageable burden for a country with our basic structure of growth potential. It is important to say that even that measure slightly overstates what the level will actually be, because that measure includes a bunch of borrowing to fund investments in the financial sector, which will have a return to them over time.

The CHAIRMAN. What would some examples be?

Secretary GEITHNER. Well, when the government makes investments in capital, it provides lending against collateral, and they will slightly overstate that ultimate burden on the economy as a whole. But in any case, in our judgment this fiscal package, if adopted by the Congress, would put us in a sustainable fiscal position over that timeframe with a level of debt-to-GDP which is stable at acceptable levels.

The CHAIRMAN. All right. Thank you.

Senator Grassley?

Senator GRASSLEY. I do not disagree with anything you just said there, but the way I like to tell my constituents is, on the annual deficit, we have a 40-year average of about 3.2 percent, and we have grown that way and have improved our economy very much and improved the standard of living. It seems to me like a 40-year average of the national debt is about 40 percent of Gross National Product.

Secretary GEITHNER. That is right. And because of the cost of the crisis and to solve the——

Senator GRASSLEY. Yes. Then it goes up to 60.

Secretary GEITHNER. That is right.

Senator GRASSLEY. Yes.

But again, I guess I would say, for 40 years, that that level of debt has not been harmful to the economy because it has been manageable.

I want to talk about just one thing. This is probably going to be semantics to you, but to some of us who take seriously a President saying he should not, or will not, increase taxes for people under $250,000, I want to explain how I think he is not abiding by that.

Now, on his cap-and-trade tax increase, it raises revenue of $646 billion over an 8-year period. This $646-billion tax increase will be paid by all Americans in the form of higher energy prices, including electricity and fuel, as well as higher taxes on all goods and services, because of shipment and other reasons.

For example, a single taxpayer making between $95,000 and $200,000 will receive no benefit under the Making Work Pay Credit. Married couples filing jointly who make between $190,000 and $250,000 do not receive any benefit whatsoever from the extension of the Making Work Pay Credit but are hit by a tax increase on the energy they use, as well as other goods and services, as a result of the cap-and-trade tax increase.

Furthermore, many Americans, including many low-income Americans, do not get the Making Work Pay Credit. For example, those Americans who are unemployed or are in school do not receive the Making Work Pay Credit, but they still will get hit with a tax increase from the cap-and-trade tax. In addition, this would impose a very large tax increase on those in the transportation industry—truckers, for example, or rural Americans who have to drive significant distances to their workplace.

Therefore, the President's cap-and-trade tax increase is inconsistent with his promise to not raise taxes a dime on those making under $250,000 if you are married, and $200,000 if you are single. Is that not correct?

Secretary GEITHNER. Senator, cap-and-trade would increase the cost of energy for those types of energy that are particularly carbon-intensive. It does increase the cost of energy. That is necessary if you are going to change how people use energy and make a serious effort to reduce energy dependence on foreign oil and to address climate change.

What the President proposes to do is to use those resources and direct them to not just facilitate the transition to a cleaner energy economy, but to offset those costs on the people most affected by them. That is, I think, a reasonable strategy. It is good policy. For people whose behavior and use of energy does not change, their cost of energy will go up.

But again, the President is proposing to devote those resources to making the Making Work Pay tax cut permanent, to facilitating the transition to more energy-efficient, cleaner energy technology, and, if there are additional resources beyond what we have laid out in the budget, then they will be devoted also to help compensate for those higher costs. But again, you cannot achieve these objectives without changing the incentives for how people use energy.

Senator GRASSLEY. This might be hard to argue against changing people's habits, but you are admitting in your answer to me—so a question: for those people who are not going to get the advantages of the Making Work Pay Credit, who are going to pay higher energy costs, which is a government-imposed requirement, that is the effect of a tax, and also, by the way, this budget does not allocate that money yet. Now, it might.

Secretary GEITHNER. Senator, the way I would say it is that, again, the resources raised by this will be devoted to offsetting those increased costs, and, if there are additional resources raised by this beyond what we identified in the budget, then those will be devoted to those people most affected by this. But again, the impact depends a little bit on what happens to behavior and how people use energy.

Senator GRASSLEY. Thank you, Mr. Chairman.

Thank you, Mr. Secretary.

The CHAIRMAN. Thank you, Mr. Secretary. This has been most productive, and we wish you well. Thank you.

Secretary GEITHNER. Thank you, Mr. Chairman.

[Whereupon, at 12:54 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Secretary Timothy F. Geithner
Opening Statement
Senate Finance Committee Hearing
March 4, 2009

Chairman Baucus, Ranking Member Grassley, 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 3.6 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.

Both our economic and financial problems are being compounded by problems in our housing market, where a record 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 last Friday's 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. In the last week alone, we 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.

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.

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.

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.

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 $5500 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.

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.

SENATE FINANCE COMMITTEE QUESTIONS FOR THE RECORD

United States Senate

Committee on Finance

Hearing on the President's FY2010 Budget

Treasury Secretary Timothy F. Geithner

March 4, 2009

Question for the Record from Chairman Max Baucus

1. You are the Managing Trustee of the Medicare Trust Fund. The Trustees issue an annual report - usually in late March - that provides information on Medicare's financial conditions.

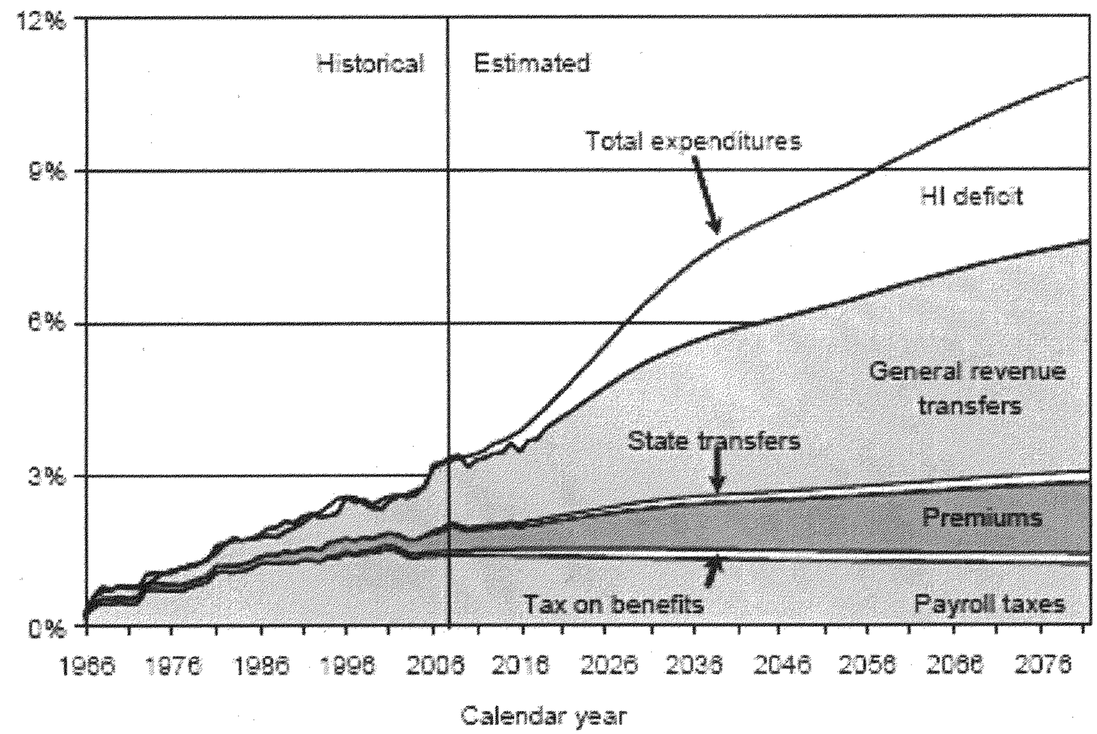
You indicated in your appearance before the Finance Committee on March 4th that the primary reason for long-run Federal Budget deficits is the rapid growth rate of health care costs in all parts of the health care system. This rapid growth rate generates rapid growth rates in Medicare and Medicaid expenditures, and these in turn are the primary reason for huge long-run Federal deficits.

In the Medicare Trustees' report for this year, do you plan to include the points made in the preceding paragraph?

The makeup of the Medicare Trustees' report is decided by the Boards of Trustees in collaboration with the Medicare chief actuary. The Boards of Trustees are made up of four ex officio members—the Social Security Commissioner and the Secretary's of Treasury, Labor, and HHS—and two members of the public (the "public trustees") who are appointed by the President and confirmed by the Senate for 4-year terms. (The public trustee slots are currently vacant.) The Treasury secretary is the managing trustee, but decisions are made on a consensus basis.

A chart like the one below from the 2008 Report will be included in the 2009 Report, along with a discussion. The chart shows projected total Medicare expenditures as a percent of GDP and financing sources provided under current law, and the HI deficit that cannot be financed under current law. The report highlights the fact that the general revenue transfers to the SMI trust fund that are called for under current law are projected to grow very rapidly, and that projected SMI and part D premiums represent a larger and larger share of projected Social Security benefit payments.

Figure II.D2.—Medicare Sources of Non-Interest Income and Expenditures as a Percentage of the Gross Domestic Product



Questions from Senator Chuck Grassley

1. According to the President's budget, the President claims that he intends to raise taxes on married couples making more than $250,000, and singles making more than $200,000.

Therefore, if one person makes $199,000 a year and another makes $52,000, but they are not married, the President's budget claims that it will not raise taxes on either of those people. However, if those two people get married, then that family will get hit with a huge tax increase under the President's budget.

There is still a marriage penalty in the higher tax brackets. For instance, the 33 percent bracket starts at about $172,000 for singles and $209,000 for married folks. However, with the President's budget, which increases the marginal tax rates from 33 and 35 percent to 36 and 39.6 percent, respectively, as well as increasing the capital gains rate from 15 percent to 20 percent, and also limiting certain itemized deductions for those in the 36 and 39.6 percent brackets to 28 percent, the marriage penalty has gone from bad to truly punitive. I think this is a huge problem. Do you agree that this is a problem in the President's budget that needs to be fixed?

The current tax code includes a marriage penalty for high-income households, a marriage penalty that was perpetuated in the tax cuts enacted in 2001 and 2003. As a result, under current law when an individual making $199,000 marries an individual making $52,000 they will likely see their taxes go up as a result. The President's budget generally does not create new marriage penalties for households that do not already face them today. In fact, the Budget does include a continuation of the increased relief from the marriage penalty in the computation of the EITC that was enacted in the American Recovery and Reinvestment Act (ARRA), thereby providing relief to those taxpayers in the greatest need. In general, the Budget also begins to restore a basic sense of fairness to the tax code, giving a generous package of tax cuts to 95 percent of working families.

2. According to the President's budget, President Obama's cap and trade tax increase raises revenue of at least $646 billion over the 8-year period from 2012-2019. This $646 billion tax increase will be paid by all Americans in the form of higher energy prices, including electricity and fuel, as well as higher prices for all goods and services, such as food and shipping costs.

To illustrate this point, Candidate Obama stated to the San Francisco Chronicle editorial board during January 2008, "Under my plan of a cap and trade system, electricity rates would necessarily skyrocket." Moreover, the President's current OMB Director, Peter Orszag, while he was the CBO Director in 2008, stated that "The higher prices caused by the cap would lower real (inflation-adjusted) wages and real returns on capital, which would be equivalent to raising marginal tax rates on those sources of income."

President Obama's budget dedicates $526 billion of the revenue from the cap and trade tax increase to extending the making work pay credit. However, the $526 billion

extension of the making work pay credit does not make up for the amount of money that taxpayers will pay in higher energy costs, as well as increased costs for all other goods and services, such as food and shipping, as a result of higher energy prices.

For instance, in 2012 alone, total cap and trade tax revenues are stated as $79 billion in President Obama's budget. Therefore, isn't the President's cap and trade tax increase 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? I heard you say on March 3rd when you were before the Ways and Means Committee that extra revenue raised by the cap and trade tax increase would be used to offset costs for people that might be most affected. However, with $120 billion of revenue raised from the cap and trade tax increase being dedicated to climate policy spending, not all of the revenue ['Tom the cap and trade tax increase is going back to the people that have to pay higher prices for energy and other goods and services, is it? Moreover, money is fungible, so there's no way to actually tell where the revenue raised by the cap and trade tax increase is going, right?

In an April 25, 2007 CBO article titled "Trade-Offs in Allocating Allowances for C02 Emissions," the CBO said that the value of emissions allowances might total up to $300 billion per year by 2020. An April 2007 study by MIT estimates that the cap and trade tax will raise revenues of $365 billion per year by 2015 and $392 billion per year by 2020. There are roughly 300 million people living in the United States, and the IRS has said that the average household size is 2.56 people. Therefore, there are approximately 117 million households in the United States. So if we use the lower MIT figure of $365 billion per year and divide that by the 117 million U.S. households, the average household will see a cap and trade tax increase of $3119. Considering that the maximum an individual can receive under the making work pay credit is $400, the burden of the cap and trade tax increase will result in a large tax increase on those families making less than $250,000 (and individuals making less than $200,000), even when the extension of the making work pay credit is taken into account, right?

Also, the making work pay credit is phased out for individuals beginning at $75,000 and is fully phased-out at $95,000, so those individuals making between $95,000 and $200,000 will be hit with a tax increase on the energy they use as well as other goods and services as a result of President Obama's cap and trade tax increase, but will receive no benefit whatsoever from the extension of the making work pay credit that you say those revenues are used to pay for. Similarly, the making work pay credit is phased out for married couples filing jointly beginning at $150,000, and is fully phased-out at $190,000.

Therefore, married couples filing jointly that make between $190,000 and $250,000 do not receive any benefit whatsoever from the extension of the making work pay credit, but are hit with a tax increase on the energy they use as well as other goods and services as a result of the cap and trade tax increase. Furthern10re, many Americans, including many low-income Americans, don't get the making work pay credit. For example, those Americans that are unemployed or are in school do not receive the making work pay credit, but they still get hit with the tax increase [Tom the cap and trade tax. In addition,

this would impose a very large tax increase on those in the transportation industry, such as truckers, as well as workers in rural areas that drive a significant distance to and from their workplace. Therefore, the President's cap and trade tax increase 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?

The President's clean energy agenda begins with an effort to lower the energy costs of American families through the American Recovery and Reinvestment Act (ARRA). A variety of tax credits, including credits for residential energy efficient investments, will reduce the carbon footprint of families and facilitate the transition to a clean energy economy while also reducing energy use and thus costs. In addition, the weatherization program provided for in ARRA will also lower energy bills by improving the energy efficiency of low-income residences.

The Administration is looking forward to working with key stakeholders and the Congress to fully develop a program to reduce greenhouse gas emissions approximately 14 percent below 2005 levels by 2020, and approximately 83 percent below 2005 levels by 2050. The program will be implemented through an economy-wide cap and trade program in which all emission allowances will be auctioned to ensure that the biggest polluters do not enjoy windfall profits. The Administration's budget reflects the proceeds from the emission allowance auction only to the extent they are reserved for clean energy technology initiatives and to compensate families through the Making Work Pay Tax Credit. (For example, many pensioners will receive Economic Recovery Payments.) Additional revenues generated from an emission allowance auction above those shown in the budget will be used to compensate vulnerable households, communities, and businesses for increased energy costs. The exact form and amount of compensation will be determined as the emission reduction program is developed.

3. On February 28, Warren Buffett released his highly-anticipated annual letter to Berkshire Hathaway shareholders. I was interested to read his concerns about the negative effects that all these unprecedented government interventions are having. As he explained it, certain companies are getting access to cheap money through government guarantees while companies like his face much higher borrowing costs, no matter how creditworthy. Mr. Buffet wrote: "Government is determining the 'haves' and the 'have-nots.' ... At the moment, it is better to be a financial cripple with a government guarantee than a Gibraltar without one."

Isn't it both fundamentally unfair and economically inefficient to create a situation where government is picking winners, and where weak, poorly-run companies can borrow money more cheaply than strong, well-run companies?

As the architect and supporter for many of the policies that he is referring to, what is your response to Mr. Buffett's concerns?

How do you plan to alter current policy to correct this problem before it does more damage to strong, well-run companies and the economy as a whole?

To address the financial crisis, the Financial Stability Plan is designed to attack our credit crisis on all fronts with our full arsenal of financial tools and the resources commensurate to the depth of the problem. We must address the uncertainty in, and the troubled assets and capital constraints of, our financial institutions as well as the frozen secondary markets that have been the source of funding for around half of our lending for everything from small business loans to auto loans.

Treasury has implemented a series of programs and initiatives designed to get credit flowing to families and businesses throughout the country. The *Capital Assistance Program(CAP)* and the *Making Home Affordable* program are important components of this package, and should help improve lending conditions in the economy. The Capital Purchase Program (CPP) is working to stabilize the financial system by injecting capital into healthy banks, enabling them to continue lending during this unprecedented crisis. The *Term Asset-Backed Securities Loan Facility* (TALF) and Public Private Investment Program (PPIP) are designed to directly address problems in the securitization markets and reestablish markets to allow loans and securities to trade more in-line with intrinsic value. Together, these programs are working to clean up lingering problems in our banking system, open up credit and begin the process of financial recovery.

We are committed to protecting taxpayers and ensuring that every dollar is directed toward lending and economic revitalization. Toward that end, the *Financial Stability Plan* is designed to institute a new era of accountability, transparency, and appropriate conditions on the financial institutions receiving funds.

4. I would like to ask about the $75 billion program you proposed to modify at-risk mortgages before the borrowers fall behind on their payments. While I support the goal of attacking the root of the problem and preventing foreclosures where we can, I am concerned that in a rush to deal with this crisis, the program could reward borrowers who committed fraud. Honest, responsible Americans are struggling and making sacrifices to pay their mortgages on time. They do not want the government taking their tax money and using it to help people who, for example, may have lied about their income in order to buy a bigger house than they could afford.

On February 12, I sent you a letter asking several specific questions about these issues, but did not receive a reply.

I have discussed these concerns with FDIC Chair Sheila Bair, and asked the FDIC Inspector General to examine the mortgage modification program she instituted at IndyMac last summer. As you develop the details of this program, I would encourage you to get input from the FDIC Inspector General about ways to avoid rewarding borrowers who committed fraud, and learn what lessons you can from the review of the program at IndyMac.

Will you do that, Mr. Geithner?

What other specific steps will you take to ensure that the program doesn't reward borrowers who committed fraud?

Will you do any review of the original loan documents to compare them with income stated on the borrower's tax return, or take any other steps to look for red-flags that might indicate fraud? If not, why not?

Will you require that borrowers sign a statement under penalty of perjury that their original loan application was free from false statements? If not, why not?

How much fraud do you think exists among at-risk mortgages with high payment-to-income ratios, and what steps are you taking to determine how much fraud exists before modifying those mortgages?

We share your concern about fraud. Protecting consumers and the MHA program from fraud and abuse is a top priority of this Administration. We have worked closely with the FDIC and a number of other federal and state agencies to have as comprehensive a fraud protection effort as possible, and we will certainly continue to work with the FDIC and others on this critical issue. In fact, on April 6th, Treasury, Justice, HUD, the FTC and the Illinois Attorney General announced a major coordinated effort to combat foreclosure rescue scams and protect consumers, including civil enforcement cases, state enforcement actions, and an alert to financial institutions. Through FinCEN, Treasury issued an advisory alerting financial institutions to the risks of emerging schemes related to loan modifications. The advisory identifies certain "red flags" that may indicate a loan modification or foreclosure rescue scam and warrant the filing of a SAR by a financial institution.

We are taking all possible measures to prevent fraud and abuse in our program. Our plan is not intended to prevent every foreclosure or to help every homeowner:

- It will apply to owner occupied primary residences only but will do nothing for speculators or house flippers.
- It will apply only to borrowers with the willingness and ability to pay an affordable mortgage but will not help those who borrowed far more than the house was worth or more than they could ever hope to repay.
- It will apply only to people with conforming mortgages and will not support mortgages over a million dollars.

- **The guidelines specify steps we are taking to ensure the program supports responsible borrowers.**
  - All borrowers must fully document income, including with signed IRS 4506T.
  - Borrowers will be required to sign affidavits, under penalty of perjury, attesting to truth of the information they provide, including that they do not have sufficient liquid assets to make monthly mortgage payments.

- The home must be a primary residence (verified with a tax return, a credit report, and some other form of documentation such as a cable bill).
- Servicers will be expected to put policies and procedures in place to indentify and prevent fraud.
- Servicers are required to keep records for audits and verification. Information they will have to record include data needed for underwriting analysis, loan modification and waterfall analysis, borrower profiles, property level information.
- The trial modification process allows a modification to start immediately, but complete documentation and verification are required prior to any government payments going out.

Extensive measures have been put in place to protect against fraud:

- Treasury has retained Fannie Mae and Freddie Mac (GSEs) as its financial agents. Each of the GSEs bring significant antifraud expertise to the Making Home Affordable (MHA) program. Freddie Mac will have responsibility for ensuring compliance by servicers; this will include fraud prevention and detection.
- The MHA website (MakingHomeAffordable.gov) displays prominent anti-fraud warnings and information.
- Servicers must provide borrowers who apply for MHA assistance with mortgage fraud warnings and contact information for borrowers to report fraud to the Special Inspector General for TARP (SIGTARP)
- As Treasury's financial agent, Freddie Mac will be using a number of fraud detection techniques in their sampling and compliance reviews. Their focus will be in three areas, borrower fraud, systemic or institutional fraud, and quality control.
    - Borrower fraud focus would include independent testing of things such as income, hardship affidavit, expenses, and owner occupancy
    - Servicer/Institutional fraud identification would include independent testing to identify items such as servicers reporting modifications that have not occurred, misrepresentation of borrowers performance, servicers charging borrowers extra fees, servicers keeping borrower incentive payments, servicers not using current credit reports.
    - Quality control will be identifying issues such as low modification of loans, bad system processes, and high default rates compared to peer servicers.
- Freddie Mac will be using a variety of techniques in their sampling and compliance reviews including independent sources to validate the data at the servicers, on-site reviews, and direct contact to validate the information given.

Questions from Senator Jeff Bingaman

1. Even though most cap-and-trade proposals would assess the levy upstream (by taxing the carbon content of fuels at their source), economists generally accept that consumers will ultimately bear the cost in the form of higher prices for goods and services - particularly for energy-intensive commodities. Low-income families will bear a cost burden that is disproportionately high relative to their incomes. Do you envision the Making Work Pay credit as sufficient to address this burden? I am particularly concerned about nonworking seniors and non-working people with disabilities who fall outside of the Making Work Pay credit. How would you envision helping them address their added costs?

The President's clean energy agenda begins with an effort to lower the energy costs of American families through the American Recovery and Reinvestment Act (ARRA). A variety of tax credits, including credits for residential energy efficient investments, will reduce the carbon footprint of families and facilitate the transition to a clean energy economy while also reducing energy use and thus costs. In addition, the weatherization program provided for in ARRA will also lower energy bills by improving the energy efficiency of low-income residences.

The Administration is looking forward to working with key stakeholders and the Congress to fully develop a program to reduce greenhouse gas emissions approximately 14 percent below 2005 levels by 2020, and approximately 83 percent below 2005 levels by 2050. The program will be implemented through an economy-wide cap and trade program in which all emission allowances will be auctioned to ensure that the biggest polluters do not enjoy windfall profits. The Administration's budget reflects the proceeds from the emission allowance auction only to the extent they are reserved for clean energy technology initiatives and to compensate families through the Making Work Pay Tax Credit. (For example, many pensioners will receive Economic Recovery Payments.) Additional revenues generated from an emission allowance auction above those shown in the budget will be used to compensate vulnerable households, communities, and businesses for increased energy costs.

2. The President's budget proposes no changes to the strong preference embedded in the Tax Code for leverage. But it is clear that the leading macro contributor to our financial dOVvntUl11 was an overleveraged economy. The President's budget fails to include any proposal to discourage over-leverage. Is this because we should take up the issue at a later point? Or, alternatively, do you consider the existing tax preferences for debt finance (as compared to treatment of equity finance) to be justified and worth continuing?

I agree that overleveraging was a key contributor to our current financial difficulty. There are many contributors to the run-up in debt, however. While many agree that we need a simpler, more transparent tax system, we need careful consideration of changes to tax treatments of debt and equity.

3. The President's budget proposes to raise $210 billion from unspecified international tax reforms. Can changes to how our tax system treats the income of US multinational companies be made in isolation from broader tax reform?

The Administration is concerned about the use of offshore structures and accounts by U.S. corporations and individuals to avoid and evade U.S. taxes. The Administration is therefore proposing a series of legislative and enforcement measures to reduce such U.S. tax evasion and avoidance.

This package of international reforms and compliance measures will not only make our tax system fairer, but they will encourage less tax gamesmanship and more jobs and investment in the United States. Broader tax reform is an issue which I look forward to discussing further with Congress.

Questions from Senator John Ensign

1. During my questioning period with you, you indicated that the President's proposed budget includes cuts to discretionary programs. Most of the savings contained in the President's budget outline presented to Congress seem to be mandatory savings, or the enactment of new taxes and user fees. Please provide a list of all discretionary program cuts, as well as the money saved by cutting the program.

As part of the President's commitment to cut the deficit in half by the end of his first term, his budget proposes a significant reduction in non-defense discretionary spending as a percentage of GDP over the course of the next decade. To put the Budget in historical context, the average level of NDD spending was 3.8 percent between 1962 and 2008. In 2009, this spending is at 4.1 percent, reflecting the extraordinary measures we are taking to stimulate the economy during this time of recession. But under the President's Budget, that percentage will decline to an average of 3.6 percent over the next ten years – and fall to 3.1 percent by 2019, the lowest since data began in 1962.

However, according to common practice, the President's Budget blueprint document only reports discretionary spending at top-line levels. The details of this spending will come with the publication of the full Budget release in May.

2. During my questioning period with you, I asked about this Administration's repeated use of the phrase "save or create" jobs related to claims about the impact of its proposals. You answered that there is an economic model in use by the Administration that validates your use of that phrase, and how 3.5 million jobs will be saved or created by your tax and spend proposals.

- **Is this estimate based upon the analysis by Christina Romer and Jared Bernstein in early January 2009? Is it correct that analysis did not reveal the mix of tax and spending envisioned in the model, nor did it use as a basis the legislative package that eventually was signed into law by the President?**

- **Will the U.S. government be using this model in the future to project the effects of all the President's proposed policies? If it is found that policies hurt long-run job growth, will the President still pursue them?**

- **Has any U.S. government agency created and run an economic model that produces an estimate on this matter, and if so, are the results the same?**

- **Please provide the results of the economic models) used by the Administration including, especially, how many jobs are expected in the baseline (i.e., absent new tax and spend policies of this Administration) for this year and for the next ten years.**

- **Please provide an analysis of the results of the model showing how many jobs are expected to be "saved or created" during each of the next ten years based on the specific tax and spend policies that are now enacted into law by the Stimulus Act. Do your results indicate anything different from the CBO analysis that found American workers would be less productive, and have lower wages as a result of this stimulus bill?**

- **What are the estimated effects of government "crowding out" of private investment through massive new borrowing according to the model?**

- **From that model, how many jobs are expected to be newly created during this year and in the next ten years given the President's proposed policies in his budget? How many jobs are expected to be lost?**

The work by Christina Romer and Jared Bernstein forms the basis of the projected effects on jobs and GDP. Their work indicated that 3-4 million jobs would be created or saved. A later version of the analysis, based on the package of spending and taxes that were included in ARRA, produced results similar to those published in early January. Like their earlier analysis, it was not based on a formal, specific macroeconometric model, but was informed by the results from several of these models. This approach is prudent, given that empirical macroeconomic models cannot deal with the complex features of the current crisis.

It is important to note that the costs of not pursuing short-term stimulus are very high; the recent GDP decline -- 6.3 percent in 2008Q4 -- as well as the sharp decline in employment -- more than 2 million in the past four months -- indicate the size of losses that we could expect to continue without ARRA. And one of the lessons of past severe crises is that governments often stop providing stimulus too soon. That is why we are reluctant to cut spending or raise taxes too quickly to bring the deficit and debt down more quickly.

The Administration has not developed views of the ARRA with alternative models. Private forecasters and the CBO, which have indicated that the downturn would be significantly larger without the ARRA, although opinions are evolving about the size. For example, in January, the CBO projected real GDP would decline 2.2 percent in 2009 without the ARRA. In March they predicted roughly a 4.5 percent decline without the ARRA. Nearly all analysts agree that the economy would be much worse off without the ARRA, and, given the state of financial markets, many are concerned that a much longer and severe downturn would occur without significant stimulus.

The offsetting effects of crowding out and productivity increases are important considerations, and these are very imprecisely understood and quantified. We agree with most economists that when the economy is working up to its potential, then increases in government deficits and debt will tend to reduce private investment spending. This can reduce productivity and lower the rate of growth of living standards. The CBO has estimated that, as a result of ARRA, growth in the long run would be lowered by 0.1 percent per year, principally through the crowding out of private investment by rising federal debt. At the same time, they note that between a quarter and a third of the ARRA's provisions are aimed at improving the economy's potential, which we believe will offset most, if not all of the reduction in private investment that can accompany higher deficits and debt. We would again emphasize that all of these estimates are very imprecise and hard to quantify, but that most economists believe the effects are small on both sides.

3. In your testimony you state, "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." Please provide specifics on that analysis, and how that figure was calculated.

The 97 percent refers to the percentage of individuals with small business income who will see either a decrease or no change in their taxes as a result of an increase in the top two regular income tax rates after 2010. Here small business income means income from sources typically associated with small businesses, such as income earned by partnerships, S corporations, and sole proprietorships.

It should be noted, however, that tax return data do not provide sufficient information to determine the size of the business generating the income reported. In addition, return data do not contain enough information to identify those persons traditionally thought of as small business owners. Thus it includes, as small business owners, high-income partners in large law firms, accounting firms, and investment partnerships, for example. Consequently, 97 percent may understate the share of small business owners who would see a tax decrease.

Questions from Senator Michael Enzi

1. The Budget caps 2020 Greenhouse Gas (GHG) emissions at 14% below 2005 levels. In 2050, the budget caps GHG emissions at 83% below 2005 levels. The budget estimates 2012-2019 climate allowance auction revenues totaling $645.7 billion, but I understand that it is possible, if not likely, that the amount will be higher. Can you explain how the Administration determined that revenue level, and the likelihood that the level is correct? How much of the funding from auction revenues does the Administration anticipate will go towards the development of clean coal technology?

The Administration is looking forward to working with key stakeholders and the Congress to fully develop a program to reduce greenhouse gas emissions approximately 14 percent below 2005 levels by 2020, and approximately 83 percent below 2005 levels by 2050. The program will be implemented through an economy-wide cap and trade program in which all emission allowances will be auctioned to ensure that the biggest polluters do not enjoy windfall profits. The Administration's budget reflects the proceeds from the emission allowance auction only to the extent they are reserved for clean energy technology initiatives and to compensate families through the Making Work Pay Tax Credit. The details of the energy technology initiatives will be determined as the emission reduction program is developed. Additional revenues generated from an emission allowance auction above those shown in the budget will be used to compensate vulnerable households, communities, and businesses for increased energy costs.

2. The Budget reinstates Superfund; repeals Last in First Out reserve accounting (LIFO); proposes a new excise tax on Gulf of Mexico oil and gas; attempts to repeal the ability to defer foreign income which many argue subjects companies to double taxation-here and abroad; repeals expensing of intangible drilling costs; and, repeals manufacturing tax deduction. These are all credits that help keep America's oil and natural gas industry competitive. As a Senator from Wyoming, I have seen energy production dip in my state because of the economic downturn, and I am concerned that these budget proposals will make the oil and gas industry less competitive with foreign industries. What is the Administration doing to ensure that we have the traditional energy development we need today at the same time we develop technology and renewable energy in the future?

The Administration's priority is the clean energy sector, which presents us with immense promise—an opportunity to develop a new industrial sector and to create high-paying jobs here at home. To spark the creation of a clean energy economy, we will make investments in the next three years to double our Nation's renewable energy capacity. We will modernize Federal buildings and improve the energy efficiency of millions of American homes, saving consumers and taxpayers billions on our energy bills. In the process, we will put Americans to work in new jobs that pay well—jobs installing solar panels and wind turbines; constructing energy efficient buildings; manufacturing fuel efficient vehicles; and developing the new energy technologies that will lead to even more jobs and more savings, putting us on the path toward energy independence for our Nation and a cleaner, safer planet in the process.

The oil and gas preferences the Administration proposes to repeal distort markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent the preferences encourage overproduction of oil, they are actually detrimental to long-term energy security and are also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the preferences must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

3. Back in December, Congress unanimously passed the Worker, Retiree and Employer Recovery Act of 2008. The provision regarding the valuation of assets for single employer plans requires Treasury and the Internal Revenue Service to issue guidance before companies can use the law's valuation provision. Congress added this provision in light of confusion over Congressional intent of the valuation provisions in ule Pension Protection Act. In light of the economic downturn, companies need this guidance as soon as practicable. How far along is Treasury with this necessary guidance?

On March 16, 2009, the IRS issued Notice 2009-22 which provided guidance on the asset valuation method for funding defined benefit plans reflecting the amendments to section 430(g) made by the Worker, Retiree and Employer Recovery Act of 2008. The notice also provided automatic approval for plans to adopt the new asset valuation method for a plan year that begins in 2008 or 2009.

Questions from Senator Orrin Hatch

1. Mr. Secretary, I would like to ask you a question or two about what to me is an unusual item in the President's budget on page 123, called "Climate Revenues."

First, as I understand from looking at the table on page 123, the almost $646 billion over ten years projected here represents just a portion of the revenue expected from so-called cap and trade auctions from a climate change bill the President hopes the Congress will pass later this year; is this correct?

In fact, I am told that the Administration expects these "Climate Revenues" to be two or even three times as high as this $646 billion. Is this correct?

Is it accurate to say that these revenues are a kind of tax on American businesses?

Whether it is called a tax or not, it seems to me to be the equivalent of a tax on U.S. businesses. As with a tax, won't the businesses that are paying these $1.3 to $1.9 trillion in "Climate Revenues" essentially have to pass through the cost of them to their customers, employees, and shareholders, just as with the income tax, in order to stay in business?

What happens in cases where the business is not able to pass through the extra cost to its customers, employees and shareholders? Does the Administration have any projections on how many jobs might be lost because businesses cannot pass these added costs along?

Moreover, many are projecting huge increases in the cost of electricity, gasoline and other goods as a result of these added costs. Now I realize that the President plans to "compensate the public" with the proceeds of this tax, just as the budget indicates in connection with the Making Work Pay credit. However, can you explain to me how the imposition of this revenue on the American industrial base coincides with the stated goal of this budget to encourage growth and recovery, and create 3.5 million jobs?

The Administration is looking forward to working with key stakeholders and the Congress to fully develop a program to reduce greenhouse gas emissions approximately 14 percent below 2005 levels by 2020, and approximately 83 percent below 2005 levels by 2050. The program will be implemented through an economy-wide cap and trade program in which all emission allowances will be auctioned to ensure that the biggest polluters do not enjoy windfall profits. The cap and trade program is not scheduled to take effect until fiscal year 2012, when economic growth is expected to have resumed.

The Administration's budget shows the proceeds from the emission allowance auction only to the extent they are reserved for clean energy technology initiatives and to compensate families through the Making Work Pay Tax Credit. The Making Work Pay Tax Credit, however, is just a first step in compensating the public. Additional revenues generated from an emission allowance auction above those shown in the budget will be used to compensate vulnerable households, communities, and businesses for increased energy costs.

In addition, to spark the creation of a clean energy economy, we will make the necessary investments in the next three years to double our Nation's renewable energy capacity. We will modernize Federal buildings and improve the energy efficiency of millions of American homes, saving consumers and taxpayers billions on our energy bills. In the process, we will put Americans to work in new jobs that pay well—jobs installing solar panels and wind turbines; constructing energy efficient buildings; manufacturing fuel efficient vehicles; and developing the new energy technologies that will lead to even more jobs and more savings, putting us on the path toward energy independence for our Nation and a cleaner, safer planet in the process.

2. Mr. Secretary, I consider you to be a leading authority on economics and a very learned and sophisticated individual. So I was very surprised and disappointed to see from your written statement that you seem to support the simplistic and often-demagogued idea that the current tax rules that allow U.S.-based multinational corporations to defer foreign earnings somehow puts those who invest and create jobs in the United States at a disadvantage. The academic literature is replete with evidence that U.S. foreign direct investment is a positive thing for the United States, both in terms of domestic employment and in terms of global competitiveness.

One system of worldwide taxation has already made the United States one of the least hospitable places in the world for a multinational company to locate. U.S.-based firms that compete with companies from practically anywhere else in the world find themselves with significant competitive disadvantages because of the way we tax international transactions.

How would making U.S. companies facing an ever-more global economy less competitive through more onerous tax rules help achieve the President's goal of encouraging growth and recovery, and creating jobs?

The Administration is concerned about the use of offshore structures and accounts by U.S. corporations and individuals to avoid and evade U.S. taxes. The Administration is therefore proposing a series of legislative and enforcement measures to reduce such U.S. tax evasion and avoidance. Some proposals will focus on those rules in our tax code that may disadvantage investment in the United States including:

- rules that allow U.S corporations to defer U.S. foreign earnings;
- rules regarding misuse of foreign tax credits; and
- rules regarding offshore transfers of intangibles and other related party transactions.

In addition, we will propose rules to help prevent offshore tax evasion and avoidance by strengthening the levy program, and strengthening reporting and withholding requirements, as well as increasing penalties for non-compliance.

The competitiveness of U.S. companies depends on many factors such as health care costs, research and development, technology investment, and worker education. The President's budget makes significant investment in all these areas, proposing, for example, to make the R&E credit permanent.

I share the President's strong desire to encourage U.S. companies to invest in research and development and thereby create good jobs here in America. I believe the ability of companies to develop new products through research and development is vital to our long-term competitiveness and is a key driver of job growth.

I also share the President's desire to help small businesses. They are an important part of our economy and a critical source of new jobs. And, unlike some large businesses that have capital reserves to ride out economic downturns, small businesses are particularly vulnerable during tough economic times such as these. The President's budget includes a number of provisions to help small business owners, including expansion of the small business stock capital gains exclusion.

I look forward to working with you to ensure the competitiveness of American businesses, large and small, during this challenging economic period and into the future.

3. Mr. Secretary, you mentioned the "Making Work Pay" tax credit as a huge part of the recently enacted American Recovery and Reinvestment Act. This economic stimulus package, as you stated, included targeted investments and tax cuts designed to get Americans back to work, and the economy growing again. In the President's budget, many of the tax increases are scheduled to begin in 2010. Administration officials have indicated that this is because the President does not want to raise taxes during a recession, and the Administration predicts the economy to recover by 2010.

If the economy is expected to recover in 2010, why is the "Making Work Pay" tax credit needed beyond 2010?

The President has pledged repeatedly to restore fairness to the tax code. Extending the "Making Work Pay" tax credit beyond 2010 makes the tax code fairer.

4. One of the Administration's priorities is to encourage financial stability, in part through increased use of equity capital by American businesses (rather than continue to overly rely on debt from the private markets). Unfortunately, in connection with commercial real estate investment, the "FIRPTA" provision of the Internal Revenue Code penalizes equity investment in U.S. real estate relative to its treatment of investment through debt. In particular, it singles out gains on sales of US real estate for US tax liability, and return filing obligations. In today's world, many believe these FIRPTA rules are an unnecessary and inappropriate barrier to equity investment in U.S. real estate by investors residing outside the U.S. Would the Administration consider modifying this questionable barrier so that equity investment in US real estate could more easily flow into the country at a challenging time?

The U.S. tax rules that apply to foreign investment in U.S. real estate reflect a balance of several different policies. The Treasury Department would be happy to work with the Congress in determining whether, and what type of, changes should be made to our FIRPTA rules.

5. I recently sent a letter to request an opinion as to whether the Treasury Department had the legal authority to provide a standby letter of credit from the Treasury Department to the Florida Hurricane Catastrophe Fund (FHFC) to facilitate liquidity in the event of multiple catastrophic hurricanes. In your opinion, does the Department have such authority?

We have received your letter and my staff and lawyers currently are exploring this issue. I will be replying to your letter with an answer soon.

Questions from Senator Bill Nelson

1. Treasury line of credit for Florida Hurricane Catastrophe Fund -- I recently sent a letter to request an opinion as to whether the Treasury Department had the legal authority to provide a standby letter of credit from the Treasury Department to the Florida Hurricane Catastrophe Fund (FHFC) to facilitate liquidity in the event of multiple catastrophic hurricanes. In your opinion, does the Department have such authority?

We have received your letter and my staff and lawyers currently are exploring this issue. I will be replying to your letter soon

2. Homeowner Affordability and Stability Plan -- Homeowners in Florida are facing foreclosures and falling housing prices at record levels. In fact, we have the second highest foreclosure rate in the country.

The new housing plan has some limitations in it that are particularly challenging for Florida's homeowners. Please address the following concerns raised by my constituents:

a. **Under the plan, if a homeowner has lost enough equity so that they are underwater on their mortgage, but can still afford to pay up to 38 percent of their monthly income, they are not eligible to take advantage of the plan.**

Borrowers who are underwater on their mortgages but can still afford to pay up to 38% of their monthly income may qualify for the Home Affordable Refinance Program. Any borrower whose first mortgage is owned or guaranteed by Fannie Mae or Freddie Mac, the value of which does not exceed 105% of the value of the home, may be eligible for the Home Affordable Refinance Program.

Our program targets up to 7 to 9 million responsible borrowers and enables them to modify or refinance their mortgages in a way that will reduce their payments. This will make it possible for those who are at risk of foreclosure to avoid being thrown out of their homes, which benefits the entire economy since the damage caused by foreclosure isn't limited to just the house that is lost. Foreclosures reduce the value of neighboring properties and lead to increased crime and property abandonment. Reducing the number of foreclosures will help stabilize home values or reduce their fall even for those who do not participate in the plan. Treasury estimates that the plan would stabilize as much as $6,000 of the average home's value at levels higher than they otherwise would have been.

In addition, for those not able to participate directly in Making Home Affordable, the Administration supports other programs, including Hope for Homeowners, which help borrowers whose mortgages are underwater refinance to new mortgages with equity in the home.

b. **A homeowner can only refinance if they owe between 80-105 percent of the current value of the house. If a person owes more than 105 percent of the current**

value of their house, they can only refinance up to 105 percent. The homeowner will have to absorb the difference.

It is important to remember that even borrowers with combined mortgages equal to greater than 105% of the value of their homes may be eligible for the Making Home Affordable Refinancing program provided their first mortgage is equal to or less than 105% of the value of their home. Based on estimates provided by Fannie Mae and Freddie Mac, we believe that the new high-LTV refinancing program will offer the opportunity to refinance to approximately 10% of all homeowners with mortgages.

In addition, homeowners with over 105% LTV may qualify for the Making Home Affordable Modification Program. The Making Home Affordable Modification Program might be an option for borrowers that meet the following initial eligibility criteria: (1) Payment on a first mortgage greater than 31% of gross income; (2) Unpaid principal balance on a first mortgage less than $729,250; (3) First mortgage originated on or before January 1, 2009; (4) Owner-occupant of a 1-4 unit home and (5) Unaffordable mortgage, perhaps due to a significant change in income or expenses.

Borrowers who are not able to qualify for a Home Affordable Refinance because their first mortgage currently exceeds 105% LTV will not be excluded on that basis from applying for a Home Affordable Modification. Those borrowers may be eligible for a Home Affordable Modification and should investigate whether they meet the eligibility criteria for a Home Affordable Modification by consulting our website at www.MakingHomeAffordable.gov and calling their loan servicer.

c. **The plan only applies to conforming loans, not jumbo loans which are common in higher cost cities, and are especially common in some pans of South Florida.**

The plan applies to all first mortgages with unpaid balances less than $729,750. Only 1.39% of first mortgages in the state of Florida fall outside of this limit according to McDash data (January 2009).

3. TARP Accountability -- By now everyone seems to agree with what I have been saying all along - that we need to do a much better job of cracking how TARP money is being spent by banks. To what extent are you currently working with other federal agencies in order to track how TARP money is being spent?

We are committed to increasing transparency and accountability. Treasury has several ongoing initiatives to measure the lending activities of banks participating in TARP Financial Stability Plan (FSP) programs.

- Quarterly Project: Together with federal banking regulators, Treasury plans to use quarterly call report data to analyze changes in the balance sheets, loan provisioning, and intermediation activities of institutions in which we have invested, and compare their activities to a comparable set of institutions that have not received TARP capital investments.

- Monthly Lending Snapshot: Because call report data is infrequent, Treasury is augmenting that analysis with a monthly survey of the 20 largest recipients of Capital Purchase Program (CCP). Treasury has already published the results of 2 monthly Snapshots. Moreover, Treasury now plans to expand this survey to all participants in the CPP, which include over 500 banks.

- Under the FSP, each Capital Assistance Program (CAP) participant must submit a plan for how they intend to use their capital to preserve and strengthen their lending capacity. These plans will be submitted during the application process, and the Treasury Department will make the relevant reports public upon completion of the capital investment in particular firms.

- CAP recipients must detail in monthly reports submitted to the Treasury Department their lending broken out by category, showing how many new loans they provided to businesses and consumers and how many asset-backed and mortgage-backed securities they purchased, accompanied by a description of the lending environment in the communities and markets they serve. This report will also include a comparison to their most rigorous estimate of what their lending would have been in the absence of government support. For public companies, similar reports will be filed on an 8K simultaneous with the filing of their 10-Q or 10-K reports.

4. Securitization market -- In Florida, we are feeling the pain of securitization markets that have shut off as our housing market continues to struggle, and our small business owners cannot get the loans they need. What do you believe are the reasons that the securitization markets remain shut off, and what else can be done to increase the flow of credit to consumers and small business owners who need it most?

With the onset of severe dislocation in the credit markets, new issuance of consumer asset-backed securities (ABS) declined precipitously in the third quarter of 2008 before coming to a virtual halt in October. Issuance of consumer ABS has remained extremely strained since October, which has significantly reduced the amount of credit extended to consumers throughout the economy. At the same time, interest rate spreads on AAA-rated tranches of consumer ABS have increased to levels well outside the range of historical experience, reflecting unusually high risk premiums.

The problems in the ABS markets reflect three developments. First, many traditional investors in AAA-rated tranches of ABS have exited the market. The remaining traditional investors have suffered substantial mark-to-market losses on their ABS portfolios, are adversely impacted by the loss of liquidity and value on their portfolios, and have little appetite to increase their ABS holdings until their existing positions trade at more normalized levels. Second, nontraditional investors such as hedge funds, which may otherwise be willing to invest in these securities, have been unable to obtain funding from banks and dealers because of a general reluctance to lend.

Third, investors are increasingly concerned about the prospect of a deep recession and resulting correlated defaults on loans to households and businesses.

To address these problems, Treasury and the Federal Reserve launched the Term Asset-Backed Securities Loan Facility (TALF). Under the first phase of the TALF, the Federal Reserve Bank of New York will lend up to $200 billion on a collateralized, non-recourse basis to holders of eligible ABS. The objective of the program is to stimulate investor demand for these securities, and thereby to reduce the funding costs of the issuers of the loans in the eligible classes. Ultimately, the program should bring down the cost and increase the availability of new credit to consumers and businesses.

The results of the first TALF operations were a success. Four deals, including three auto securitizations and one credit card securitization, were brought to the market. They totaled $8.5 billion, with just under $5 billion financed through TALF. On the small business front, the Obama Administration announced on March 16 its intention to purchase Small Business Administration (SBA) securities in order to unlock credit for small businesses. These purchases should start shortly and will focus on buying securities backed by the SBA's 7(a) and 504 first-lien lending programs. Treasury expects these purchases to increase the flow of credit to small businesses throughout the country.

5. Retirement savings -- Recent declines in the stock market have wiped away a lifetime of retirement savings for millions of Americans. Many who have already retired are being forced back to work to make ends meet. I do not see anything on the tax side of the budget that provides relief to the workers and retirees that have seen their retirement savings decimated. Do you have thoughts on what we can do to help those with dwindling 401(k)s, particularly on the tax side of the budget? Should we extend and/or modify the moratorium on mandatory distributions from retirement accounts to allow individuals to delay withdrawals, and give their retirement accounts an opportunity to recover? Should we reduce the taxation of Social Security benefits to provide relief to retirees that have suffered substantial losses?

I share your concerns about the effect of the recent stock market declines on the financial wellbeing of the elderly. But I think it is too early to consider remedies, as I expect those asset prices will recover as the economy recovers. And when and if relief is needed, it needs to be targeted toward those that truly need it. We must keep in mind that any reduction in taxation on today's elderly must be made up with higher taxes on today's young and the generations that follow. Also, I think we should primarily seek programs that address systemic problems. Everyone potentially benefits if systemic decline is avoided.

6. Financial stabilization fund -- The budget sets aside $250 billion in a reserve fund for financial stabilization, but provides little information on the types of events or conditions that would trigger use of those funds. Is it your view that the financial stabilization funds will only be used to ensure that our banking system continues to function? Or do you anticipate that the reserve fund could be used to address other areas that are weighing

heavily on financial markets, such as the home foreclosures and the crisis in the housing market?

We can't predict the future, but to be responsible, the Budget reflects a possibility that more funds may be needed to stabilize the financial system. We cannot predict what specific needs might require attention in the future, but all of our efforts are and will continue to be designed to restore the health of our financial system while preserving the best interests of the taxpayers.

7. Long-term fiscal imbalance -- I recognize that the current economic crisis has required short-term deficit spending to help reverse the downturn. But I am concerned that the 10-year projections in the President's budget do not go far enough in addressing our long-term challenges. If the economy does not bounce back as quickly as you anticipate, will the President look for additional savings to ensure that the long-term budget deficits do not grow worse than they already are?

We agree that an unchecked rise in federal debt poses a threat to the U.S. economy in the longer term. The consequences of an out-of-control rise in the federal debt are very troublesome. Federal borrowing would crowd out private investment. Beyond some point, the rise in borrowing would raise interest rates, hurt private investment, and, in the long run, reduce productivity growth, which would reduce our long-run rise in the average standard of living. We share your commitment to keeping the rise in federal debt to a minimum, and at the same time, agree with you that the deficits we will run over the next few years are an investment in near-term economic growth and the stability of our economy. Our near-term deficits are an investment we need to make to clean up long-standing problems we have inherited. Without the programs these deficits support, the economy would be much worse. Banks would fail, businesses that rely on credit would fail, millions more would lose their jobs and their homes.

At 12.3 percent of GDP in FY2009, the budget deficit does reach a very high level, but we project that the growing economy and the end of temporary spending measures will cause the deficit to decline sharply going forward. In the long term, the deficit remains at about 3 percent of GDP, and the level of publicly held debt (net of assets we've acquired) is stable at about 60 percent of GDP in the long term (through 2019). That is still less than the current level in other major economies, like Japan.

We are pursuing every avenue we can to protect taxpayers from unnecessary programs and un-needed taxes. We have already identified several of these and plan to eliminate or phase them out. In the longer term, the key to reducing budget deficits and the federal debt is reducing the burden of entitlement spending. We look forward to working with Congress to develop workable solutions to the challenge of rising entitlement spending.

Questions from Senator Debbie Stabenow

1. In the next few months, I look forward to working with the Administration and my colleagues on reforming our financial regulatory system. The financial crisis has highlighted the urgency of reforming our 20th Century regulatory structure to adapt to a 21st Century marketplace. To restore trust in the markets, we must have a system with increased transparency, accountability and protections for consumers and investors.

Nowhere have the inherent problems in our current structure been more visible than through the abuses of AIG. The insurance company took advantage of the regulatory gaps in our financial oversight system, which has led to a bailout of $163 billion in taxpayers' funds -- that's almost one-fourth of the total rescue package for one company (FYI: Not all the funds are from TARP, but this is just to put it in perspective).

What lessons have we learned from these abuses, and how can we create a system that ensures they never happen again?

Federal authority over major investment banks and insurance companies was weak or nonexistent leading up to the current financial crisis. While these companies often owned insured depository institutions, the institutions they owned were not considered "banks" for purposes of the Bank Holding Company Act. Thus, the companies were able to escape the more stringent supervision and regulation applicable to Bank Holding Companies.

The existence of an adequately empowered federal systemic risk regulator would have helped to prevent the excessive risk taking, excessive leverage, and inadequate liquidity risk management practices that imperiled Lehman, Bear, and AIG. The systemic risk regulator would have powerful authority and responsibilities to impose strict capital, liquidity, and risk management requirements on all firms like Lehman, Bear, and AIG whose disorderly failure has the potential to cause great harm to the financial system and the economy.

The systemic risk regulator would also be charged with imposing standards on systemically important bank holding companies that are stricter and more robust than the existing approach. These new standards would focus on macro-prudential supervision and regulation of the systemic firms rather than focusing primarily on the safety and soundness of the subsidiary banks of these firms.

A special resolution regime for systemically important non-bank financial firms also would have substantially improved the government's toolkit for handling the failure of one of these firms and potentially avoided the financial market turmoil that followed Lehman's bankruptcy.

2. The credit crisis has made it impossible for the automakers to raise capital in order to invest in advanced technology, or to even meet their daily operational costs. Dealers and suppliers do not have the credit necessary to finance inventory or cover capital costs. Motor vehicle financing companies lack the funds to support dealers, and to make loans to consumers. Add in plummeting consumer demand due to the unavailability of auto

loans and the economic realities facing American families, and we have the perfect storm.

We must address the lack of financing available in order to have a viable automobile industry in this country. The Treasury and the Federal Reserve announced yesterday the launch of the Term Asset-Backed Securities Loan Facility or TALF program designed to unfreeze and lower interest rates for consumer and business credit.

However, the program requires a AAA (triple A) rating from two rating agencies. Given the uncertainty introduced by on-going discussions between the U.S. government and the automakers, some of the major rating agencies have declared that they cannot affirm or assign AAA-ratings for securitizations of dealer floorplan financing lines.

Does TALF favor nontraditional asset-backed securities investors? Who benefits from TALF?

The Term Asset-Backed Securities Facility (TALF) has been tremendously beneficial to the auto industry, given that of the four TALF deals completed, three were auto-based. Securities collateralized by autos represent the second largest sub-sector in the asset-backed securities (ABS) market, and the ability to access TALF will help automakers as a source of funding floor plan and consumer credit, and concurrently will help Americans as it will lower interest rates for auto financing.

TALF is focused on both non-traditional asset backed securities and traditional asset backed securities, with the ultimate intention being to improve credit conditions for consumers, students, and small businesses. When TALF was initially launched it assisted borrowers owning eligible collateral, including assets backed by auto loans, student loans, credit card loans and small business loans fully guaranteed as to principal and interest by the Small Business Administration (SBA). In mid-March, The Federal Reserve Board announced that the set of eligible collateral for loans extended by TALF is being expanded to include four additional categories of ABS:

- ABS backed by mortgage servicing advances
- ABS backed by loans or leases relating to business equipment
- ABS backed by leases of vehicle fleets
- ABS backed by floorplan loans

Mortgage servicing advances are loans extended by residential mortgage servicers to cover payments missed by homeowners. Accepting ABS backed by mortgage servicing advances should improve the servicers' ability to work with homeowners to prevent avoidable foreclosures. The additional new ABS categories complement the consumer and small business loan categories that were already eligible--ABS backed by auto loans (including auto floorplan loans), credit cards loans, student loans, and SBA-guaranteed small business loans.

3. Issuers have also traditionally relied heavily on purchasers of subordinated securities to fund the remaining portion of consumer assets. This market was dominated by risk takers like hedge funds. This market is closed, and TALF will not purchase subordinated securities. How will TALP address this important liquidity source?

The eligible collateral under TALF are only those that have the highest long-term or short-term credit rating from two or more major nationally recognized statistical rating organizations (NRSROs) and do not have a credit rating below the highest investment-grade from a major NRSRO. Treasury and the Federal Reserve believe that setting high eligibility requirements is critical for taxpayer protection.

4. Under TALF, hedge funds will purchase the AAA securities to obtain the higher yield with substantially less risk. It is questionable whether traditional investors (such as money funds and insurance companies) will participate. How will you address the potential the capital market liquidity squeeze when the program terminates, and hedge funds no longer participate as equity returns will no longer be available?

It is encouraging that $8.3 billion of credit card and auto asset-backed securities (ABS) was issued coincident with the initial TALF subscription in March, more than doubling the amount of credit card and auto ABS that had been issued since last October. Moreover, ABS associated with the initial TALF subscription priced at spreads between 100 and 200 basis points lower than previously issued ABS, marking a substantial decline in interest rates for these instruments. The narrowing of spreads has reportedly generated a renewed enthusiasm for ABS following the program's initial success, with more issuance being developed. It is important to note that these deals came to market with only 57% of the capital coming from TALF loans, indicating that a significant number of traditional investors participated on an unlevered basis. As market conditions improve it is expected that traditional buyers will increasingly resume their participation in the ABS market.

5. Issuers do not directly benefit from the pricing offered by the Fed. Will TALF allow issuers to directly pledge their own securities to avoid equity driven pricing by hedge funds?

Issuers of asset-backed securities (ABS) do directly benefit from the TALF lending program offered by the Fed by helping stimulate the market for ABS and allowing for lower interest rates. At the height of the dislocation in the credit markets, new issuance of consumer ABS declined precipitously in the third quarter of 2008 and came to a virtual halt in October.

Since the TALF program was announced in November 2008, ABS spreads in the secondary market for TALF-eligible asset classes have narrowed significantly, although they still remain well above their historic norms. Five-year spreads on AAA-rated credit card ABS tightened to 300 basis points above Libor in early February 2009, down from 550 to 600 basis points in December; 3-year AAA-rated auto ABS spreads tightened to 350 basis points above swaps in March, down from 600 basis points in early January; and Federal Family Education Loan Program (FFELP) student loans ABS of similar tenors and ratings fell to 175 basis points in

February, down from 350 basis points in early January. Market participants noted that spreads on each of these asset classes benefitted from inclusion in the original TALF design, even before the first subscription date.

It is encouraging that $8.3 billion of credit card and auto ABS was issued coincident with the initial TALF subscription in March, more than doubling the amount of credit card and auto ABS that had been issued since last October. Moreover the ABS associated with the initial TALF was priced at 100 and 200 basis points lower than previously issued ABS. The narrowed spreads in the secondary market have reportedly generated a renewed enthusiasm for ABS and as a result more issuance is reportedly being developed.

6. Domestic auto finance companies account for approximately one half of the $120 billion asset-backed security floor-plan financing market. How will TALF help floorplan financing, given that one major rating agency has downgraded all three domestic auto finance companies floorplan asset-backed security structures to below AAA?

The auto finance companies are currently working with the ratings agencies to determine how they can attain AAA status. Concurrently, we have been having direct conversations with the auto finance companies to see how we might assist them in gaining the floorplan funding that they may need.

7. Why does floorplan ABS have the most punitive haircuts? Especially considering that the small business dealers across the country have much of their personal net worth tied up in dealerships, and yet they have more punitive haircuts than subprime retail (for 3 years, 14 percent floorplan versus 9 percent subprime retail).

The haircuts of a particular asset class are determined by multiple factors, including historical losses and secondary trading levels. Floorplan asset-backed securities (ABS) have been particularly impacted by the threat of a potential bankruptcy in the domestic auto car manufacturers, and as a result the secondary levels have traded at levels that translate into higher haircuts. Haircuts are reevalutated on a monthly basis. Treasury and the Federal Reserve believe that setting high eligibility requirements is critical for taxpayer protection.

8. Secretary Geithner, you recently announced the creation of a public-private investment fund. This diverged from the "aggregator bank" concept in part to avoid the overpayment of the illiquid assets. You stated that your "objective is to use private capital and private asset managers to help provide a market mechanism for valuing the assets." However, I am still concerned regarding the price that the government will pay for these assets. If we pay too much, then banks will profit at the taxpayer's expense, and if we pay too little, then banks would have to take further losses. This has been particularly concerning following the report by the Congressional Oversight Panel that found the Treasury overpaid as much as $78 billion for the assets it purchased under TARP.

I know you are still working out details on the proposal, but how will you determine the

market value for these assets and ensure that the government is being a proper steward of the taxpayer's dollars?

Central to the Public-Private Investment Plan (PPIP) is the government's partnering with private capital and private fund managers to facilitate a market mechanism for valuing troubled assets. Private sector investors competing with one another will establish the price of the loans and securities purchased under the PPIP. Since TARP funds will be invested alongside private capital, the taxpayer has the opportunity to participate in the asset's upside alongside with the private investors. Further, private market participants along with the government stand to lose their entire investments in a downside scenario.

Creating equity partnerships with private investors should serve to both protect the interests of taxpayers over the long-term and help restore liquidity and enable price discovery for troubled assets in the short-term. The partnership approach is superior to the alternative of either hoping for banks to gradually work these assets off their books or of the government's purchasing the assets directly. Simply hoping for banks to work legacy assets off over time risks prolonging a financial crisis as in the case of the Japanese experience. If the government acts alone in directly purchasing legacy assets and securities, taxpayers will assume all of the myriad risks, including the risk that the taxpayers will overpay if government employees are setting the price for those assets. By using attractive government financing and equity co-investment with private sector investors, substantial purchasing power will be created, making the most of taxpayer resources. Once loan and securities markets have been reestablished, loans and securities should trade more in-line with intrinsic value. Throughout the process, the government's interests are well-aligned with those of the private sector.

9. I am very happy to see that the Administration included the expansion of the provision that was originally included in the recovery package which allowed for an extended 5-year carryback of net operating losses. After the recovery package was signed into law, I heard from a number of companies, large and small, that were very surprised the provision had been dramatically scaled back, and worried that their businesses might not be able to stay afloat.

I am very supportive of the overall recovery package, and think it goes very far in job creation and helping to get our economy back on track. Including the NOL provision, I think will help to make sure that more sectors of the business community will be able to participate in the recovery.

Can you tell me if this provision will be for 2008 and 2009 -- just like in the version that passed the Senate?

The Administration recognizes the importance of the carryback issue to the thousands of affected businesses that did not qualify for the 5-year NOL carryback provision enacted in the recent recovery package. The Administration believes that, in the current economic climate, it is appropriate to expand the 5-year NOL carryback provision to a broader group of affected businesses.

10. I am very happy that the TAA program was funded in this year's budget. I have been a strong supporter of TAA and its expansion. However, I am very concerned that the TAA for Communities program, which would cost $230 million to implement, was not funded at all. The TAA for Communities Program is critical for those commlU1ities affected by production shifts.

It qualifies those eligible communities for planning grants, sector partnership grants and community college and career training grants. Moreover, preference is given to small- and medium-sized communities that might not qualify for other types of grants. It helps them to retrain their workers and get back on solid footing.

Can you give me some insight as to why, particularly during this economic downturn, we would not make TAA as far-reaching as possible, and fund what has been authorized? It is clear that production shifts to other countries have caused not just American companies and workers to suffer, but whole communities, and it is critical that we do everything we can for them. Chairman Baucus and Senator Grassley worked with their House counterparts to get this included in the recovery package, and to not fund it seems wasteful.

The Administration is very concerned about the plight of workers and communities affected by the economic downturn and global trade, and substantial funding for TAA is supported in the Administration's budget.

The Commerce Department would be responsible for a Trade Adjustment Assistance (TAA) for Communities program, and it is better positioned to address these questions. In general, however, I understand that the Economic Adjustment Assistance Program within the Economic Development Administration, in combination with other existing Federal programs, can achieve the objectives that ARRA proposes for TAA for Communities.

11. I am very excited about the great strides we have made on wiring our health care system thanks to last year's Medicare law, and the recently passed recovery package. Of course none of this matters if providers do not begin purchasing the equipment, and the first payment incentives in Medicare and Medicaid should begin in 2011.

As HHS moves forward, what steps is the Administration taking or considering in making sure that providers are aware of these changes?

This Administration understands the immense transformative power of technology and innovation and how they can improve the lives of Americans. By maximizing the power of technology, we can strengthen the quality and affordability of our health care system.

This program is primarily under the prevue of Health and Human Services. The American Recovery and Reinvestment Act of 2009 and the Medicare Improvements for Patients and

Providers Act of 2008 included important tools designed to encourage the investment in and adoption of health information technology.

12. Additionally, what steps are the Administration considering 10 make sure this process is easy for providers to understand, especially the hardship waivers? These are big changes for providers to get ready for, and it may be daunting for safety-net providers in our rural and urban centers.

As you know, this program is primarily under the purvue of Health and Human Services.

13. The President's proposed budget plan for Fiscal 2010 includes a provision to repeal the LIFO (Last In First Out) method of accounting for inventory. The LIFO method, which is used to determine financial statement earnings and tax liability, allows taxpayers to match current sales revenues with current inventory replacements costs. By taking into account the cost of replacing inventory. LIFO results in a more accurate measure of the financial condition of the business and the amount of economic income that should be taxed. A wide range of businesses use the LIFO method including manufacturers, retailers, wholesalers and mining companies.

Repealing LIFO would increase tax bills for many manufacturing companies, and the hundreds of thousands of U.S. businesses of all sizes in all industry sectors. If this change is mandated, those companies that use this method would be subject to a one-time tax on their LIFO reserves and would face higher tax bills in the future. The LIFO method is a well-established accounting method that taxpayers have been able to use for almost 70 years, and can hardly be called a loophole.

What is the rationale behind getting rid of an accounting method that provides a more accurate method for calculating economic income?

The LIFO method creates a tax benefit for taxpayers with inventories. The value of which is highest for those whose inventory values increase the most over time. Our proposal to repeal LIFO will equalize the taxation of inventory profits across different companies and will simplify both taxpayer compliance and IRS enforcement.

14. Do you see a danger in "changing the rules midstream" for the many companies that have used the LIFO method in good faith, and now would be penalized by a tax increase?

The LIFO method defers, rather than exempts, the payment of taxes on inventory gains. Its repeal will simply end past and future LIFO deferrals, and will treat current LIFO taxpayers and current FIFO taxpayers equally.

Nevertheless, because we recognize that companies have used the LIFO method in good faith, the President's budget proposal would not demand an immediate payment of past deferred taxes, but would allow former LIFO taxpayers to repay the deferred amount of tax, without interest, over a period of eight years.

15. For companies using LIFO, repeal would result in both a retroactive and prospective tax increase, drawing cash from needed investment and job creation. Are you concerned about the potential impact of this tax increase on these businesses?

We are cognizant of the potential impacts of repealing the LIFO inventory method.

We have designed the proposal to repeal LIFO with the additional tax burden in mind. First, we have proposed delaying implementation of the measure until 2012. At this point, we are confident that the economy will be well on its way to recovery and sustained growth. Second, to the extent firms have suffered losses during the recession, they will have carryover net operating losses to help offset any potential tax liability arising from the end of LIFO deferral. Third, the proposal would allow current LIFO taxpayers to repay the deferred tax amounts over a period of eight years, without incurring any interest charges on these deferred amounts. We anticipate that this period is long enough to allow taxpayers to absorb the additional expected tax liabilities.

16. An earlier proposal to repeal LIFO was scored by the Joint Committee on Taxation in 2007 to raise about $100B over ten years. Based on the document released last week by the Administration, the current LIFO repeal proposal would raise some $60B. Can you explain why these revenue estimates are so different?

The Administration's score for LIFO repeal is $18 billion (23 percent) lower than JCT's current score for this same proposal ($79 billion). The relative magnitude of this differential is not unusual for proposals that affect corporations, and more broadly, businesses in general. Also, because the LIFO tax and financial data supplied by firms is incomplete, estimates may vary.

Questions from Senator John Kerry

1. Last week, I introduced the TARP Taxpayer Protection and Corporate Responsibility Act of 2009 which would prohibit TARP recipients from hosting entertainment or holiday parties during the year or the year immediately following a year for which they receive TARP funds. Last year, I was concerned about the practice of AIG, and I believe that recent actions of Northern Trust Corporation indicate that companies are still not acting responsibly during these difficult economic times. I realize the recently passed American Recovery and Reinvestment Act of 2009 requires the Secretary of Treasury to provide guidelines on expenditures, including entertainment and events. I am concerned that guidelines are not enough, and we will continue to hear that these expenses were not made with TARP funds. Money is fungible, and I believe that companies receiving federal assistance should focus on improving lending. Do you think guidelines are enough or further action needs to be taken?

Treasury is committed to fully implementing all of the regulations and restrictions imposed under the Emergency Economic Stabilization Act (EESA) and the American Recovery and Reinvestment Act (ARRA).

2. Last week you appeared on the News Hour, and you talked about the new Capital Assistance Program. You said that the process was going to take some time, and that n cloud of uncertainty has been over the financial system for the past eighteen months. How long is "some time?" We have seen different approaches over the last few months, and the stock market is now below 7,000. I think we need an immediate solution that works, and do you think now you have the right approach?

We believe that the new Capital Assistance Program (CAP) will help to restore confidence that the nation's largest banking institutions have a sufficient capital cushion against larger than expected future losses, should they occur due to a more severe economic environment, and will help to support lending to creditworthy borrowers.

As a part of CAP, federal banking supervisors are currently in the process of conducting forward-looking assessments to evaluate the capital needs of the major U.S. banking institutions under a more challenging economic environment. We will have the results from these assessments in the beginning of May. Should the results indicate that an additional capital buffer is warranted, banks will have an opportunity to turn first to private sources of capital. In light of the current challenging market environment, the Treasury is making government capital available immediately through the CAP to eligible banking institutions to provide this buffer.

3. The way I understand the Capital Assistance Program is that banks participating in the Capital Assistance Program will receive a preferred security that is convertible into common equity. I am concerned that this approach 'Will not be enough. Under this approach, do you think banks will be able to remove toxic assets from their books? I am afraid many banks will be back for more assistance like we have seen with Citigroup. Will you be doing more to address toxic assets?

To address the challenge of legacy assets, Treasury – in conjunction with the Federal Deposit Insurance Corporation and the Federal Reserve – has announced the Public-Private Investment Program as part of its efforts to repair balance sheets throughout our financial system and ensure that credit is available to the households and businesses, large and small, that will help drive us toward recovery.

Using $75 to $100 billion in TARP capital and capital from private investors, the Public-Private Investment Program will generate up to $500 billion in purchasing power to buy legacy assets – with the potential to expand to $1 trillion over time. The Public-Private Investment Program will be designed around three basic principles:

1) ***Maximizing the Impact of Each Taxpayer Dollar:*** By using government financing in partnership with the FDIC and Federal Reserve and co-investment with private sector investors, substantial purchasing power will be created, making the most of taxpayer resources.

2) ***Shared Risk and Profits With Private Sector Participants:*** The Public-Private Investment Program ensures that private sector participants invest alongside the taxpayer, with the private sector investors standing t o lose their entire investment in a downside scenario and the taxpayer sharing in profitable returns.

3) ***Private Sector Price Discovery:*** To reduce the likelihood that the government will overpay for these assets, private sector investors competing with one another will establish the price of the loans and securities purchased under the program.

We believe that this program will work to relieve the problem of legacy loans and legacy securities that are clogging the balance sheets of financial firms—helping to restart the flow of credit.

Questions from Senator John Cornyn

Section 199 - Domestic Manufacturing Deduction

The Administration's budget proposes to repeal the Section 199 manufacturing deduction for income derived from American oil and gas operations. This deduction allows American companies to deduct a portion of their income derived from domestic manufacturing and production activities. It was part of the American Jobs Creation Act of 2004, which was passed to help create U.S. jobs.

1. Mr. Secretary, how does this specific proposal meet the President stated goal of "creating or saving 3.5 million jobs"?

2. How does this specific proposal increase American production of energy, and help spur job creation?

3. How does this specific proposal reduce our reliance on foreign sources of energy?

The Administration's priority is the clean energy sector, which presents us with immense promise to develop a new industrial sector and create high-paying jobs here at home. To spark the creation of a clean energy economy, we will make the investments in the next three years to double our country's renewable energy capacity. We will modernize Federal buildings and improve the energy efficiency of millions of American homes, saving consumers and taxpayers billions on our energy bills. In the process, we will put Americans to work in new jobs that pay well—jobs installing solar panels and wind turbines; constructing energy efficient buildings; manufacturing fuel efficient vehicles; and developing the new energy technologies that will lead to even more jobs and more savings, putting us on the path toward energy independence for our country and a cleaner, safer planet in the process.

The manufacturing deduction effectively provides a lower rate of tax. The lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent the lower tax rate encourages overproduction of oil and gas, it is actually detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Enhanced Oil Recovery (EOR)

The Administration recognizes the need to pursue carbon capture and sequestration, which will most likely be part of any cap-and-trade tax proposal. The Administration's budget estimates substantial revenues from a cap-and-tax plan ($652 B), which would be derived from a substantial tax increase on all American businesses and consumers. Not

to mention an increase in higher energy costs as well. The President has also committed to responsible production of oil and natural gas, yet the budget repeals tax incentives used to keep oil and gas production economical.

4. How is the policy approach justified to raise taxes and energy costs on Americans, and repeal the means to provide lower-cost energy and goods?

The repeal of the tertiary and Enhanced Recovery (EOR) tax credits is also puzzling. EOR by definition meets both the criteria for carbon sequestration and responsibly producing oil and natural gas.

The Department of Energy's National Energy Technology Laboratory indicates that substantial geologic storage potential exists in oil and gas reservoirs for sequestering large amounts of C02. That's the same C02 that would need to be sequestered from electrical power plants and other large fixed-point sources in order to meet any cap-and trade requirements. But the Administration's budget would eliminate tax credits for tertiary injectants and EOR. Repealing these provisions will reduce the amount invested in the infrastructure necessary to tap domestic energy resources, and to build the pipeline infrastructure essential for large scale carbon capture and storage.

5. What is the rationale for including the repeal of the tertiary and EOR credits when doing so would impede C02 EOR, a key component of enhancing domestic energy security and sequestering C02 emissions?

Congress and the Administration are now adding trillions of dollars to the federal debt. Because investors covet the relative security of Treasury securities during this time of crisis, the Treasury is able to attract all the money it needs while paying extremely low interest rates on all of this new borrowed money. However, the day will come when those securities will mature. To retire that debt, the Treasury will need to float new debt at what is almost certain to be much higher interest rates.

The Administration's priority is the clean energy sector, which presents us with immense promise to develop a new industrial sector and create high-paying jobs here at home. To spark the creation of a clean energy economy, we will make the investments in the next three years to double our country's renewable energy capacity. We will modernize Federal buildings and improve the energy efficiency of millions of American homes, saving consumers and taxpayers billions on our energy bills. In the process, we will put Americans to work in new jobs that pay well—jobs installing solar panels and wind turbines; constructing energy efficient buildings; manufacturing fuel efficient vehicles; and developing the new energy technologies that will lead to even more jobs and more savings, putting us on the path toward energy independence for our country and a cleaner, safer planet in the process.

The oil and gas preferences the Administration proposes to repeal distort markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent the preferences encourage overproduction of oil, they are actually detrimental to long-term energy security and are also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the preferences must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

The Administration supports innovative energy technologies including carbon sequestration projects, renewable energy projects, and transmission projects that avoid, reduce, or sequester air pollutants and greenhouse gases while simultaneously creating green jobs and contributing to long-term economic growth and international competitiveness. The 2008 Energy Improvement and Extension Act (EIEA) created a tax credit equal to $20 per metric ton of qualified carbon dioxide captured at a qualified facility and permanently disposed of in secure geological storage. The EIEA also provided a credit of $10 per metric ton for qualified carbon dioxide that is captured at a qualified facility and used as a tertiary injectant in a qualified enhanced oil recovery (EOR) or natural gas recovery project. The credits apply only through the end of the calendar year in which it is determined that more than 75 million metric tons of qualified carbon dioxide have been captured and disposed of or used as a tertiary injectant. The American Recovery and Reinvestment Act of 2009 (ARRA) modified the credit to make the credit available for carbon dioxide used as a tertiary injectant only if it is permanently sequestered in secure geological storage following its injection. Under existing law, a taxpayer may use naturally occurring $CO2$ deposits as a tertiary injectant and is not required to permanently sequester captured $CO2$. Therefore, the existing EOR credit does not target the sequestration of industrial greenhouse gas emissions as well as does the new carbon sequestration tax credits. EIEA also provides $1.25 billion of tax credits for investments in advanced coal projects and gasification projects that satisfy carbon capture and sequestration requirements.

In addition, ARRA provides funding to meet the President's campaign commitment to build commercial scale coal-fired plants with carbon capture and storage technology through public-private partnerships. The Energy Department will also scale up its demonstration projects for geologic storage for carbon dioxide. Combined, this funding will set the foundation for significant efforts to mitigate greenhouse gas emissions from coal-fired power plants. ARRA also established a tax credit equal to 30 percent of the qualifying investment with respect to any qualified advanced energy project. A qualifying advanced energy project includes a project that re-equips, expands or establishes a manufacturing facility for the production of property designed to capture and sequester carbon dioxide emissions (as well as technology for the production of renewable energy, energy storage, energy conservation or efficient transmission and distribution of energy).

6. Is the Federal Government setting itself up for a new long-term crisis as the cost of maintaining the federal debt explodes in the years to come?

We agree that an unchecked rise in federal debt poses a threat to the U.S. economy in the longer term. The consequences of an out-of-control rise in the federal debt are very troublesome. Federal borrowing would crowd out private investment. Beyond some point, the rise in borrowing would raise interest rates, hurt private investment, and, in the long run, reduce productivity growth, which would reduce our long-run rise in the average standard of living. We share a strong commitment to keeping the rise in federal debt to a minimum. At the same time the deficits we will run over the next few years are an investment in near-term economic growth and the stability of our economy. The deficits are an investment we need to make to clean up long-standing problems we have inherited. Without the programs these deficits support, the economy would be much worse. Banks would fail, businesses that rely on credit would fail and millions would lose their jobs and their homes.

At 12.3 percent of GDP in FY2009, the budget deficit does reach a very high level, but we project that the growing economy and the end of temporary spending measures will cause the deficit to decline sharply going forward. In the long term, the deficit remains at about 3 percent of GDP, and the level of publicly held debt (net of assets we've acquired) is stable at about 60 percent of GDP in the long term (through 2019). That is still less than the current level in other major economies, like Japan.

We are pursuing every avenue we can to protect taxpayers from unnecessary programs and un-needed taxes. We have already identified several of these and plan to eliminate or phase them out. In the longer term, the key to reducing budget deficits and the federal debt is reducing the burden of entitlement spending. Our initiative in health care reform can help to contain medical care inflation, which is a key reason Medicare costs are rising sharply. We look forward to working with Congress to develop workable solutions to the challenge of rising entitlement spending which will help us keep federal debt from exploding.

7. In the past, many of my colleagues have mentioned their concerns about foreign investors buying and owning proportionally more and more of our debt. What does the President's budget assume in this regard?

The budget makes no particular assumption about who is buying our debt, and we anticipate that throughout the forecast, there will continue to be a mix of domestic and foreign purchasers. It seems likely that the current trend toward foreign purchases will continue, because we anticipate that the U.S. will continue to grow and maintain its position as the world's preeminent economy. Foreign investment in our government securities is a welcome sign of confidence in the U.S. as a safe and profitable destination for investment funds.

Small Business & Capital Gains

During the campaign, we heard a number of times from then-Senator Obama, that he favored a zero capital gains for small business investments. The Administration's budget has a narrower proposal of zero capital gains, but doesn't go into effect until 2014 -- and this comes after capital gains are increased by a third -- going from 15% to 20% in 20 II. So first in line is to raise taxes on investments in small business, and then somewhere, someday, sometime down the road we might cut those taxes. Mr. Secretary, now, during this economic downturn, is the time that we should be rewarding risk takers and entrepreneurs - not five or six years down the road. We need to be encouraging investments in new and expanded small business today.

Mr. Secretary, please explain to me why the Administration believes we should not put in place today a zero capital gains tax as an incentive for investment in new and expanded small business

8. Why if it makes sense in 2014, doesn't it make sense today?

The Administration proposal for a zero capital gains rate would be effective immediately upon enactment for all new investments in qualified small business stock. Thus, we believe it does have the immediate effect that you are seeking. In addition, on other investments, the Administration proposes to extend the current zero and 15 percent tax rates on capital gains and dividends for families with income under $250,000. This will provide a significant incentive for investment, reducing the double tax on corporate income, reducing the tax bias favoring debt financing and may improve corporate governance because of the financial discipline imposed on corporations paying dividends.

9. Don't we need new investments today to create jobs?

The Administration has a strong program to create jobs and get the economy back on track for long-term economic growth and prosperity. For example, the Budget proposes permanent extension of the Research & Experimentation (R&E) Credit, which is currently scheduled to expire at the end of 2009. In addition, the Administration proposes making the credit more generous for qualified energy research. This expansion is particularly important as we try to increase our energy independence. Extending the R&E credit would promote job creation by providing certainty to businesses that the tax credit will be available for projects that have not yet been initiated, or would not be completed prior to its current expiration date. The proposal for a 100 percent capital gains exclusion for investment in qualified small business stock will promote job creation by small business, which is a major source of new jobs in the economy.

Trade

Mr. Secretary, trade is important to my home state of Texas. In fact, trade is helping Texans work through the current recession.

10. With international trade contracting and protectionist sentiment rising, should the U.S. take active steps to reduce trade barriers and encourage trade?

Trade is a significant and increasingly important factor contributing positively to the U.S. and global economies. We are working to fight protectionist pressures internationally. There is a danger of incremental build-up of trade restrictions, which could strangle trade and slow the recovery and even exacerbate the current economic turmoil. Therefore, G-20 Leaders pledged last November "to refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports." We have encouraged international efforts to monitor trade and investment measures. A recent WTO report found that trade protectionism has increased, but there is no sign of imminent descent into high intensity protectionism and retaliation.

Eliminating barriers to trade in the face of serious turmoil in the global economy and financial markets will be a challenge. Nonetheless, we believe a strong, market-opening agreement for both goods and services in the WTO's Doha Round negotiations would be an important contribution to addressing the global economic crisis. The Administration is committed to working with our trading partners for such an outcome. The Administration is also prepared to build on existing Free Trade Agreements in a responsible and transparent manner. We will conduct extensive outreach and discourse with the public on whether these agreements appropriately advance the interests of the United States and our trading partners. And, we will consider proposals for new bilateral and regional agreements when they promise to deliver significant benefits consistent with our national economic policies.

We are also working within the G-20 process to ensure that declines in short-term trade finance are not further restraining trade in an already recessionary environment. Our hope is to have Leaders announce a major multilateral initiative of governments and multilateral development banks to provide additional financing capacity and mechanisms to promote trade flows.

11. Do you think talk of renegotiating the North American Free Trade Agreement (NAFTA) simply creates more uncertainty, and make matters worse?

The Obama Administration will work with Canada and Mexico to identify ways in which NAFTA could be improved without having an adverse effect on trade. We fully understand how important the Mexican and Canadian markets are to U.S. producers.

The President already has spoken to President Calderon and Prime Minister Harper about the opportunity to "improve" NAFTA, and make it more relevant to the situation that the three countries currently face over sixteen years after the original agreement was signed. That's in the interest of all three partners. We will do this in a collaborative spirit and emphasize ways in which this process can benefit the citizens of all three countries.

Small Business & IRS Budget

Mr. Secretary, I want to ask you about the IRS budget. The Administration is proposing a record increase in the IRS enforcement budget -- $7.1 billion increase in the next five years - that is a lot more IRS auditors that will be knocking on people's doors during this Administration. I have several concerns about this - but the one I want to address today is as it relates to small businesses. The IRS has been increasing significantly its audits of small and medium businesses. This has been in response to the chorus about the tax gap coming from Congress.

Mr. Secretary, for a small business an audit is devastating. The time and money to deal with an audit can be overwhelming. Further, unlike a big business that has a team of lawyers and accountants to deal with the IRS, it is often the small business owner

themselves that has to take time from running the business and deal with questions and issues relating to the audit.

One problem is this, and I hear it time and time again from businesses in Texas, even when the IRS is wrong on an issue, it will take too much time and money for a small business to fight, and the IRS knows it. So the small business reaches into its pocket and pays the bill. Of equal concern, it is because of fear of an IRS audit that small businesses often do not even take advantage of the tax incentives that Congress has provided, and for which they qualify, such as the R&D Credit. That is not how things should work.

To give you an idea of the anti-small business mindset of some at the IRS - they recently issued guidance to their agents that if a business had a refund claim for the R&D tax credit - even if it was 90% correct - the expectation was that the agent would impose a 20% penalty on the 10% that was disallowed. I would ask that you revisit this guidance Mr. Secretary, and see if this makes sense to you personally.

12. Mr. Secretary, I also want you to advise me for the record on what actions you will take to ensure quality control of IRS employees - that they know the law and apply it fairly and accurately. Specifically, what testing and education will you put in place for IRS examiners of small businesses, and how will you hold IRS employees and managers accountable for poor quality of work?

Examination employees who are hired as Internal Revenue Agents in the Small Business/Self-Employment Division are required to have 24 college credit hours of accounting as well as 6 credit hours of other business courses such as business law. Each examiner receives extensive formal training in tax law, consisting of 400 hours in the classroom. The formal classroom training consists of a series of courses covering ever more complex aspects of the tax law, including rules applicable to individuals, corporations, and flow-thru entities. Classroom training is supplemented with periods of on-the-job training, totaling 35 weeks, in which the employee examines tax returns under the direction and guidance of a more senior agent and manager who evaluate progress towards achieving training objectives.

Examiners receive additional technical training in the form of 40 hours of Continuing Professional Education each year to ensure they remain current with tax law changes and updates. Additionally, examiners who specialize in specific area of emphasis are provided additional training in their area of specialization, such as international and flow-thru transactions. Managers interact with employees frequently, conduct interim and completed case reviews and field visitations, and regularly evaluate the quality of the employee's work. Employees are held accountable for their individual performance and receive a mid-year review as well as an annual rating. Managers utilize the Embedded Quality Review System (EQRS) to evaluate agents' case work. Managers' involvement and engagement with their employees is also reviewed and evaluated by the managers' superiors through EQRS as well as live case reviews. Neither the manager nor the examiner may be evaluated on the tax enforcements results of an examination, which ensures that all taxpayers are treated fairly. The examination function has a Case Quality Action Plan in place to ensure the IRS continues to focus its efforts on improving the accuracy and consistency of its work product.

In addition to the emphasis on knowledge of the tax law and its proper application, the IRS's Technical Services staff provides an objective review of the work performed in the field through the National Quality Review System. Results of the statistical samples of closed cases are made available to IRS management to identify opportunities for focus and training. The Technical Service staff also serves as a resource for field personnel and provides guidance through Technical Digest publications and group meeting presentations.

Small Business & R&D Credit

13. Mr. Secretary, the economists have made it clear that a key to turning around our economy is going to be improving productivity and expanded research and development. That is why I have supported the R&D tax credit, and why I'm pleased to see the Administration has requested that it be made permanent. However, there are two issues that I would like to bring to your attention regarding the R&D credit.

The first is that the way the law is currently written - and proposed by the Administration - tens of thousands of small businesses cannot take advantage of the R&D Credit. 'That is because the small business owners, overwhelmingly pass-through entities, are barred from taking the R&D credit if they are subject to the individual AMT. This means that the tax incentive provided for Research and Development doesn't do a dime of good for thousands of small businesses - businesses that are often doing the most innovative and cutting-edge work in this country.

I would ask Mr. Secretary, that as we work on the R&D Credit - that the Administration commit to working with us to ensure that these small businesses can take advantage of these tax incentives as well. It makes no sense that General Motors gets the R&D credit, but the small business owners that provide the parts for GM are disqualified from taking the R&D credit under the tax laws.

The second issue I am concerned about is the administration of the R&D Credit. Everyone in Congress supports the R&D credit, and so does the Administration. What is not well understood is that the IRS is putting a lot of sand in the gears that is preventing businesses, particularly small businesses, from taking the credit.

I wrote to your predecessor, Secretary Paulson, about problems with the administration of the R&D Credit - particularly for small businesses - on August 21, 2008. I have heard first-hand from small businesses in my state that the R&D credit is being administered by the IRS in a heavy-handed way, particularly in regards to record-keeping. The effect is to discourage small businesses from taking the R&D credit.

I would ask you to review my letter of August 21, 2008, which is in the record, and for the record, provide me your detailed response on what steps you will be taking to ensure that the R&D Credit is administered in a manner that allows and encourages small businesses to take advantage of this incentive.

Chairman Baucus, Senators Grassley and Hatch have been leaders in the R&D credit in the Senate and on the Finance Committee, long before my joining the Committee. I hope to work with them on this issue to ensure that the R&D credit benefits not just large companies, but the small business community as well.

We agree that the R&E tax credit is a valuable tool in encouraging technological developments that are an important component of economic growth. For this reason, the President's proposed budget includes the permanent extension of this important tax credit.

Under current law, while taxpayers large and small may not immediately avail themselves of the benefits of the R&E credits in taxable years in which they are subject to the alternative minimum tax, unused R&E credits may be carried forward for 20 years to offset any regular income tax that the taxpayers may owe in future years. The Treasury Department is happy to discuss this further with you, your staff and other Members and staff of the Finance Committee.

JOHN CORNYN
TEXAS

United States Senate
WASHINGTON, DC 20510–4305

August 21, 2008

The Honorable Henry M. Paulson, Jr.
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

I have long been a supporter of the R&D tax credit, which provides important incentives to Texas businesses to remain competitive in our world economy. The R&D credit was originally enacted in 1981, during a period of high energy prices and stagflation. The economy is experiencing similar difficulties today. Congress views the R&D tax credit as a way to encourage innovation and job creation here at home. It is for this reason that I am troubled by information I have received which highlights that some Internal Revenue Service (IRS) employees are undermining Congressional intent of the R&D tax credit through unreasonable and uninformed enforcement actions.

The IRS enforcement actions are discouraging many deserving small and medium-sized businesses in Texas and throughout the country from taking the R&D credit. The businesses that claim the R&D credit are typically manufacturing and technology-based companies which employ significant numbers of scientists, engineers, software developers, biologists and chemists who are the lifeblood of our economy. We need to be helping these companies receive the R&D tax credit, instead of putting roadblocks in their way. The IRS' actions are creating a gap between what Congress intended and what is actually occurring across the country.

My comments on this matter are based on discussions with businesses located in Texas. There are three issues of concern: 1) overly burdensome and unreasonable recordkeeping requirements; 2) length and delay of audits combined with 'per se' denials; and 3) poor training of IRS employees on the R&D tax credit-- leading to the application of old and defunct legal standards which contradict Congressional intent.

While the IRS has made the R&D tax credit a top audit issue (Tier I), the IRS has failed to recognize the realities of small and medium-sized businesses in regard to the level of record-keeping and documentation that is available. When the IRS places the same paperwork burden on a small business as it does on a Fortune 1000 company with an army of accountants and tax lawyers, the IRS is not taking the available resources and cost of these requirements into account. The IRS' actions are effectively creating its own tax policy: small and medium-sized businesses should not apply for the R&D tax credit. This was not the intent of Congress. The R&D tax credit was enacted to benefit companies of all sizes, not just the Fortune 1000.

I am also troubled that the IRS is subjecting these same businesses to audits of 18 to 24 months before they receive (or are denied) the credit. This length of audit time is expensive and means owners are spending time with the IRS instead of managing their business. In addition to the length of time of audits, all businesses, not just small and medium business owners, are frustrated by often having to deal with IRS agents who are not properly trained. While there are certainly some IRS employees conducting these audits professionally and knowledgeably, it is my understanding that too often, these audits are being performed by IRS employees who have little to no training with the R&D tax credit. A typical experience is for a business to be subject to audit for several months and then have the R&D tax credit denied after only a superficial review at best by an IRS employee. The business then has to fight the issue at the appeals level – something that is particularly difficult for a small or medium-sized business to do with limited resources. Fortunately, businesses are, in many cases, resolving these matters at the appeals level and receiving the R&D credit that Congress intended to provide them. But this is likely an indication that many IRS examiners and managers at the audit level have not been properly trained. This is not an efficient way of administering the credit. A business should not have to expend significant funds and run the gauntlet to realize the tax benefits they deserve.

This 'per se' denial by IRS agents goes directly against public statements made by the current IRS Commissioner during the Federation of Tax Administrators' (FTA) 76th Annual Conference that Tier I compliance issues such as the R&D credit are indicators to spark further dialogue between agents and taxpayers and are not intended to be 'per se' disallowed. Unfortunately, 'per se' denial is exactly what is occurring when it comes to the R&D credit. I worry that IRS senior management is not aware of what is happening in the field, resulting in a gap between rhetoric and reality. This gap needs to be eliminated.

I strongly urge that senior Treasury and IRS officials meet with the leading representatives of businesses and establish 'standards of practice' that are fair and equitable and that mitigate the overly burdensome documentation requirements. These requirements should be based on recordkeeping that the business maintains through its normal course of operations. I also request that only IRS agents who have received proper training and have demonstrated the requisite knowledge be allowed to conduct audits and examinations of R&D credit claims. A well-trained and technically knowledgeable agent is a benefit to not only to the IRS but also to taxpayers who have a greater comfort that their R&D audit will result in a fair and objective decision. I would encourage the IRS to consider having leading providers of R&D tax credit services provide technical training to IRS agents on a national level. Finally, the IRS needs to establish steps that will improve quality control, an end to 'per se' denials and a reasonable time period for R&D examinations of small and medium-sized businesses.

Thank you for your time and consideration on this important issue. I request that you please provide a response within 30 days. Please contact Andrew Siracuse at 202-224-8255 if your staff has any questions.

Sincerely,

John Cornyn

John Cornyn

U.S. Senate

Cc: Chairman Max Baucus, Senate Finance Committee
Ranking Member Charles Grassley, Senate Finance Committee
Eric Solomon, Assistant Secretary for Tax Policy
Douglas Shulman, IRS Commissioner