

GAO

Testimony

Before the Senate Committee on Homeland Security and  
Governmental Affairs

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21<sup>st</sup> CENTURY  
CHALLENGES

Reexamining the Base of  
the Federal Government

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



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Chairman Collins, Senator Lieberman and Members of the Committee:

Thank you for the opportunity to present and discuss the report we are issuing today entitled *21<sup>st</sup> Century Challenges: Reexamining the Base of the Federal Government*. We appreciate the interest and support of this committee and others of GAO's efforts to produce this report for the Congress. This report stems from the recognition that the Congress faces a daunting challenge: the need to bring government and its programs in line with 21<sup>st</sup> century realities. This challenge has many related pieces: addressing our nation's large and growing long-term fiscal gap; deciding on the appropriate role and size of the federal government—and how to finance that government—and bringing the panoply of federal activities into line with today's world. We believe that GAO has an obligation to assist and support the Congress in this effort. The reexamination questions discussed in today's report are offered in that spirit: they are drawn primarily from the work GAO has done for the Congress over the years. We have attempted to structure questions that we hope you will find useful as the Congress determines which issues it plans to examine and act on. Many of the questions in this report do not represent immediate crises, however many pose important longer term threats to our country's fiscal and economic, and national security as well as the quality of life for our children and grandchildren.

As I have said before, our nation is on an unsustainable fiscal path. Long-term budget simulations by GAO, the Congressional Budget Office (CBO), and others show that, over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. All reasonable simulations indicate that the problem is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. Rather, a fundamental reexamination of major spending and tax policies and priorities will be important to recapture our fiscal flexibility and ensure that our programs and priorities respond to emerging social, economic, and security changes and challenges.

Ultimately, this reexamination will entail a national discussion about what Americans want from their government and how much they are willing to pay for those things. It will also involve how the government should conduct its business for the 21<sup>st</sup> century. Many, if not most, current federal programs and policies were designed decades ago to respond to trends and

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challenges that existed at the time of their creation. Our recent entry into a new century has helped to remind us of how much has changed in the past several decades—whether it be rapid shifts in the aging of our population, the globalization of economic transactions, the significant advances in technology, and changing security threats. If government is to effectively address these trends, it cannot accept its existing programs, policies and activities as “givens.” Outmoded commitments and operations can constitute an encumbrance on the present and future that can erode the capacity of the nation to better align its government with the needs and demands of a changing world and society.

Rethinking the base of existing federal spending and tax programs is an important step in this process. A periodic reexamination offers the prospect of addressing emerging needs by weeding out programs and policies that are outdated and ineffective. Those programs that remain relevant can be updated and modernized by improving their targeting and efficiency through such actions as redesigning allocation and cost sharing provisions, consolidating facilities and programs and streamlining and reengineering operations and processes. The tax policies and programs financing the federal budget can also be reviewed with an eye toward the overall level of revenues that are necessary to fund government operations and commitments, the mix of taxes that should be used, and the extent to which the tax code is used to promote certain societal objectives.

In my testimony today I will try to provide a context for, and a guide to, this report. First, I will talk about why and how we developed this report. Next, I will touch on the long-term fiscal challenge, which provides the primary impetus for this overall reexamination effort. The bulk of my statement deals with five of the fundamental trends that are shaping the world and the federal role in our economy and our society: demographics, global interdependence, economic change, evolving security threats and governance challenges. In this discussion I’ll talk about how the issues discussed in this report can be used to assist you in your policy making and oversight activities.

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## Reexamining the Base of the Federal Government

Let me start by telling you a little more about the genesis of this report. GAO has long had a statutory responsibility for monitoring the nation’s finances. Recently, in our role as the auditor of the U.S. government’s consolidated financial statements, we included an emphasis paragraph in the audit report for fiscal year 2004 expressing our concerns about the unsustainability of the nation’s long-term fiscal outlook. This conclusion

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was based on the results of fiscal year 2004 and GAO's long-term budget model, which we have used since 1992.

Moreover, as you know, in our role as the audit, evaluation, and investigative arm of the Congress, we have provided our perspectives on a wide range of key performance and accountability challenges facing the federal government, both in numerous reports and testimonies over the years and compendiums such as our high-risk reports. We have also looked forward by developing a strategic plan, consistent with the Government Performance and Results Act (GPRA) and in consultation with the Congress, identifying the emerging forces and trends that are impairing the United States, its citizens and its position in the world.

Given these trends and challenges facing the nation, we believe that GAO now has an obligation to provide policymakers with the benefit of our institutional knowledge to identify selected areas throughout government that could be considered for reexamination and review. Drawing on our past and pending work—about 90 percent of which is either requested by the Congress or required by law—we have provided examples of the kinds of hard choices stemming from these challenges in the form of questions for elected officials and other policy makers to consider. These 21<sup>st</sup> century questions cover discretionary spending, mandatory spending including entitlements, as well as tax policies and programs.

The specific 21<sup>st</sup> century questions were based, in part, on GAO's strategic plan for serving the Congress,<sup>1</sup> which identified major trends that will shape the federal role in the future. (See table 1.)

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**Table 1: Strategic Plan Themes**

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|-------------------------------------|-----------------------------------|
| • Long-Range Fiscal Challenges      | • Demographic Shifts              |
| • Changing Security Threats         | • Science and Technology Advances |
| • Increasing Global Interdependence | • Quality of Life Trends          |
| • The Changing Economy              | • Changing Governance Structures  |

Source: GAO.

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<sup>1</sup> GAO, *Strategic Plan for Serving the Congress and the Nation, 2004-2009* (Washington, D.C.: March 2004).

These trends, along with GAO’s institutional knowledge and issued work, helped us identify the major challenges and specific questions. The specific questions were informed by a set of generic evaluation criteria which are useful for reviewing any government program or activity; these are displayed in table 2.

**Table 2: Illustrative Generic Reexamination Criteria**

Relevance of purpose and the federal role	Does it relate to an issue of nationwide interest? If so, is a federal role warranted based on the likely failure of private markets or state and local governments to address the underlying problem or concern? Does it encourage or discourage these other sectors from investing their own resources to address the problem?
	Have there been significant changes in the country or the world that relate to the reason for initiating it?
	If the answer to the last question is “yes,” should the activity be changed or terminated, and if so, how? If the answer is unclear as to whether changes make it no longer necessary, then ask, when, if ever, will there no longer be a need for a federal role? In addition, ask, would we enact it the same way if we were starting over today? Has it been subject to comprehensive review, reassessment, and re-prioritization by a qualified and independent entity? If so, when? Have there been significant changes since then? If so, is another review called for?
	Is the current mission fully consistent with the initial or updated statutory mission (e.g., no significant mission creep or morphing)? Is the program, policy, function, or activity a direct result of specific legislation?
Measuring success	How does it measure success? Are the measures reasonable and consistent with the applicable statutory purpose? Are the measures outcome-based, and are all applicable costs and benefits being considered? If not, what is being done to do so?
	If there are outcome-based measures, how successful is it based on these measures?
Targeting benefits	Is it well targeted to those with the greatest needs and the least capacity to meet those needs?
Affordability and cost effectiveness	Is it affordable and financially sustainable over the longer term, given known cost trends, risks, and future fiscal imbalances?
	Is it using the most cost-effective or net beneficial approaches when compared to other tools and program designs?
	What would be the likely consequences of eliminating the program, policy, function, or activity? What would be the likely implications if its total funding was cut by 25 percent?

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**Best practices** If it fares well after considering all of these questions, is the responsible entity employing prevailing best practices to discharge its responsibilities and achieve its mission (e.g., strategic planning, organizational alignment, human capital strategy, financial management, technology management, acquisitions/sourcing strategy, change management, knowledge management, client/customer service, risk management)?

Source: GAO.

In the report, we describe the forces at work, the challenges they present, and the 21<sup>st</sup> century questions they prompt, in each of 12 broad areas based in large measure on functional areas in the federal budget, but also including governmentwide issues and the revenue side of the budget as listed in table 3.

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**Table 3: Twelve Reexamination Areas**

<b>Mission Areas</b>	
Defense	Natural Resources, Energy & Environment
Education & Employment	Retirement & Disability
Financial Regulation & Housing	Science & Technology
Health Care	Transportation
Homeland Security	
International Affairs	
<b>Crosscutting Areas</b>	
Governance	Tax System

Source: GAO.

Our report contains over 200 individual illustrative questions in these 12 areas. In the remainder of my statement I will discuss some of the questions in the context of the major strategic challenges facing the nation.

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## Long-term Fiscal Challenge Provides Reexamination Impetus

Chairman Collins, the nation is facing a range of important new forces that are already working to reshape American society, our place in the world and the role of the federal government. Our capacity to address these and other emerging needs and challenges will be predicated on when and how we deal with our fiscal challenges—the long-term fiscal pressures we face are daunting and unprecedented in the nation’s history. The size and trend of our projected longer term deficits means that the nation cannot ignore the resulting fiscal pressures—it is not a matter of whether the nation deals with the fiscal gap, but when and how. Unless we take effective and timely

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action, our near-term and longer-term deficits present the prospect of chronic and seemingly perpetual budget shortfalls and constraints becoming a fact of life for years to come. Not only would continuing deficits eat away at the capacity of everything the government does, but they will erode our ability to address the wide range of emerging needs and demands competing for a share of a shrinking budget pie.

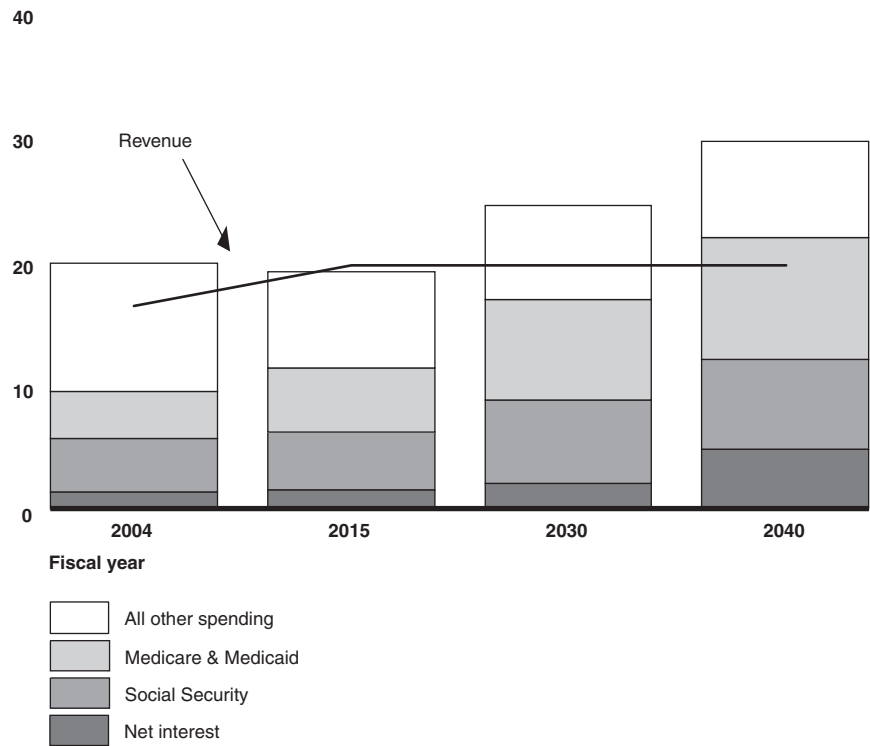
GAO's long-term simulations illustrate the magnitude of the fiscal challenges we will face in the future. Figures 1 and 2 present these simulations under two different sets of assumptions. In the first, simulation is based on the CBO January baseline—constructed according to the statutory requirements for that baseline.<sup>2</sup> Consistent with these requirements, this simulation assumes no changes in current law, that discretionary spending is assumed to grow with inflation for the first 10 years, and that tax cuts which are currently scheduled to expire will expire. After 2015, discretionary spending is assumed to grow with the economy, and revenue is held constant as a share of GDP at the 2015 level. In the second figure, only two assumptions are changed: (1) discretionary spending is assumed to grow with the economy rather than merely with inflation for the entire period (not just after 2015), and (2) all tax cuts which are currently scheduled to expire are made permanent. For both simulations Social Security and Medicare spending is based on the 2004 trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted. Medicaid spending is based on CBO's December 2003 long-term projections under mid-range assumptions.

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<sup>2</sup> The Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015* (Washington, D.C.: January 2005).

**Figure 1: Composition of Spending as a Share of Gross Domestic Product (GDP) Under Baseline Extended**

50 Percent of GDP



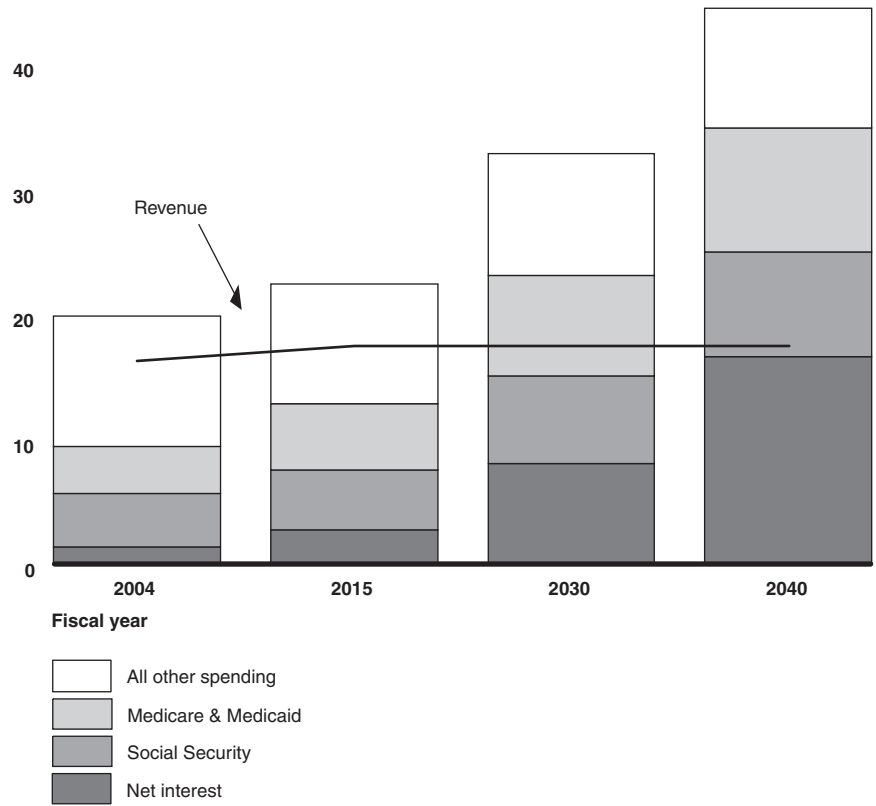
Source: GAO's January 2005 analysis.

Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.



**Figure 2: Composition of Spending as a Share of Gross Domestic Product Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended**

50 Percent of GDP



Source: GAO's January 2005 analysis.

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

As both these simulations illustrate, absent policy changes on the spending and/or revenue side of the budget, the growth in spending on federal retirement and health entitlements will encumber an escalating share of the government's resources. Indeed, when we assume that recent tax reductions are made permanent and discretionary spending keeps pace with the economy, our long-term simulations suggest that by 2040 federal revenues may be adequate to pay little more than interest on the federal

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debt. Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance. Although revenues will likely be part of the debate about our fiscal future, making no changes to Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require at least a doubling of taxes in the future—and that seems both inappropriate and implausible. Accordingly, substantive reform of Social Security, Medicare and other major mandatory programs remains critical to recapturing our future fiscal flexibility.

The government can help ease our nation’s future fiscal burdens through actions on the spending and/or revenue side that reduce debt held by the public, increase saving for the future, and enhance the pool of economic resources available for private investment and long-term growth. Economic growth is essential, but we will not be able to simply grow our way out of the problem. The numbers speak loudly: Our projected fiscal gap is simply too great. Closing the current long-term fiscal gap would require sustained economic growth far beyond that experienced in U.S. economic history since World War II. Tough choices are inevitable, and the sooner we act the better.

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## Fundamental Forces Will Test Existing Policy Frameworks

Fiscal necessity can become the mother of invention and of much needed reforms in government programs and activities. The nation’s continued economic progress, social well being and national security in the 21<sup>st</sup> century will in large part depend on how we adapt and respond to these rapid changes and growing fiscal challenges.

We hope the reexamination questions presented in our report today can facilitate a fundamental overview and reexamination of the base of government programs, policies and activities. As I noted earlier, in organizing these questions we started with major trends that are shaping the world and the federal role in our economy and our society. I’d like to spend some time today discussing five of the trends we have identified in our strategic plan for serving the Congress and how they prompt the need to consider the base of government across several of the 12 areas addressed in the report. I’ll start with demographics, including the aging of our population, and then discuss increasing global interdependence, economic change, evolving security threats and changing governance systems.

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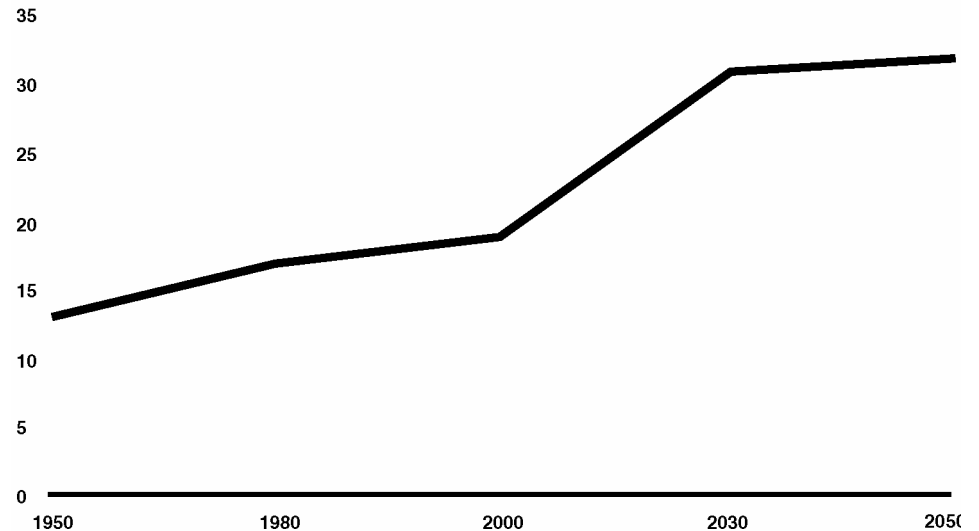
## An Aging Population

As the baby boomers age, people will live longer and spend more time in retirement. As shown in figure 3, the U.S. elderly dependency ratio is expected to continue to increase.<sup>3</sup> The proportion of the elderly population relative to the working-age population in the U.S. rose from 13 percent in 1950 to 19 percent in 2000. By 2050, there is projected to be almost one elderly dependent for every three people of working age<sup>4</sup>—a ratio of 32 percent. Additionally, the average life expectancy of males at birth has increased from 66.6 in 1960 to 74.3 in 2000, with females at birth experiencing a rise from 73.1 to 79.7 over the same period. As general life expectancy has increased in the United States, there has also been an increase in the number of years spent in retirement.

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**Figure 3: U.S. Elderly Dependency Ratio Expected to Continue to Increase**

Elderly dependency ratio (in percent)



Source: Population division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: 2002 Revision and World Urbanization Prospects: 2001 Revision. Data for 2030 - 2050 are projected.

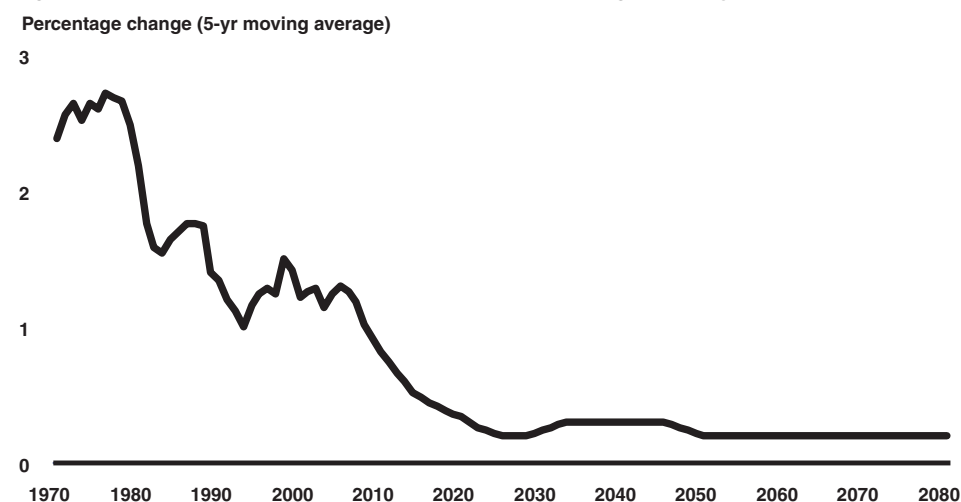
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<sup>3</sup> The elderly dependency ratio is the ratio of the population aged 65 years or over to the population aged 15 to 64.

<sup>4</sup> For the Social Security system—which does not cover the entire U.S. population—the ratio of beneficiaries to workers is estimated to be 1 to 2 at that time.

A falling fertility rate is the other principal factor underlying the growth in the elderly share of the population. In the 1960s, the fertility rate was an average of three children per woman. Today it is a little over two, and by 2030 it is expected to fall to 1.95. The combination of these factors means that annual labor force growth will begin to slow after 2010 and by 2025 is expected to be less than a fifth of what it is today. (See fig. 4.) Thus, relatively fewer workers will be available to produce the goods and services that all will consume. Lower labor force growth will lead to slower growth in the economy and to slower growth of federal revenues.

**Figure 4: Labor Force Growth Is Expected to Slow Significantly**



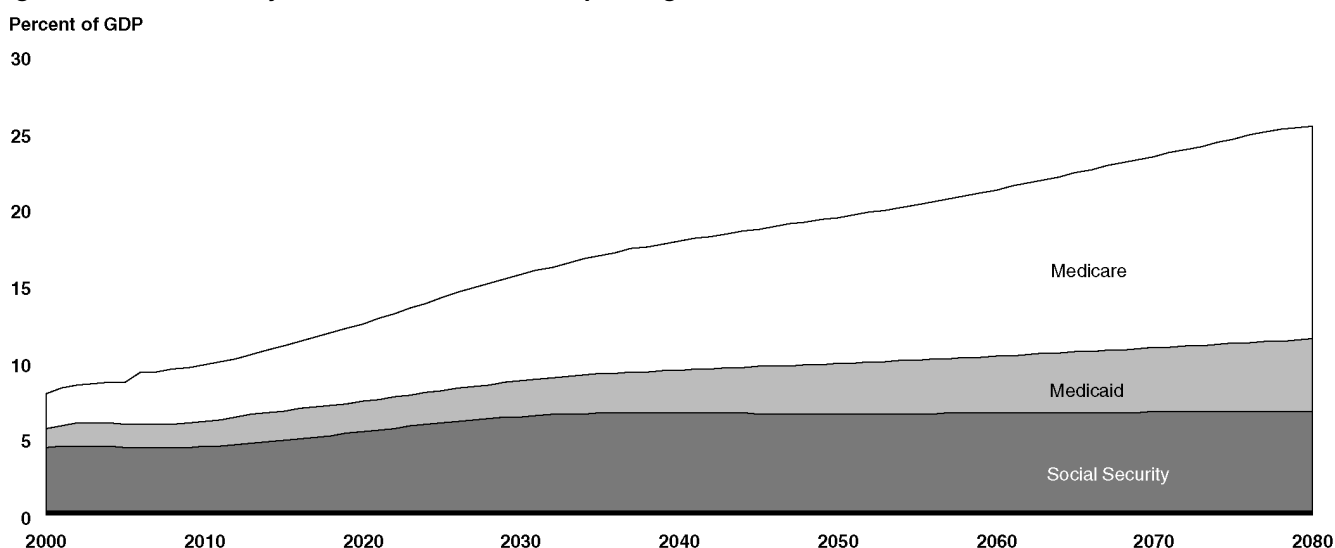
Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

Note: Percentage change is calculated as a centered 5-year moving average of projections based on the intermediate assumptions of the 2004 Trustees' Reports.

As noted earlier, these trends have major implications for federal budget policy and will prompt a reexamination of national retirement programs, health care and workforce policies. Although considerable uncertainty surrounds long-term budget projections, we know two things for certain: the population is aging and the baby boom generation is approaching retirement age. The aging population and rising health care spending will have significant implications not only for the budget, but also for the economy as a whole. Figure 5 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2004 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for these entitlement programs combined will grow to 15.6

percent of GDP in 2030 from today's 8.5 percent. It is clear that, taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

**Figure 5: Social Security, Medicare, and Medicaid Spending as a Percent of GDP**



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

Note: Social Security and Medicare projections based on the intermediate assumptions of the 2004 Trustees' Reports. Medicaid projections based on CBO's January 2005 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.

These trends portend major changes in our current national social insurance system. A core element of the system was a certain and secure retirement income component—with Social Security as a foundation. Social Security is intended to be supplemented by a private pension system and individual savings arrangements—which, in combination, sought to conquer the long-standing economic fear of poverty in old age. Effectively responding to the long-term and structural challenges discussed above will entail fundamental and comprehensive reassessment of each of the key components of our retirement and disability system.

Social Security could be brought into balance over the next 75 years in various ways. If reforms were to be instituted today, an immediate increase in payroll taxes of 15 percent or an immediate reduction in currently promised benefits of 13 percent, or some combination of the two would be

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required to bring the program into balance. Waiting to reform the system will require even greater changes as time passes. Encouraging older workers to extend their labor force participation can also improve the solvency and sustainability of the program while enhancing overall economic growth.

Weaknesses in the nation's private pension system have also become evident. Traditional defined benefit plans where employers rather than employees bear the risk of investment have been shrinking for decades, and recent terminations of plans have threatened the solvency of the Pension Benefit Guaranty Corporation (PBGC). Policymakers will need to consider how to best encourage wider pension coverage and enhance pension security. They will also need to consider how the private pension system and any related reforms will interact with prospective changes in Social Security.

Meanwhile, federal disability programs, such as those at the Social Security Administration (SSA) and the Department of Veterans Affairs (VA), are challenged by significant growth over the past decade that is expected to surge even more as increasing numbers of baby boomers reach their disability-prone years. Federal disability programs remain mired in concepts from the past and are poorly positioned to provide meaningful and timely support for workers with disabilities. Advances in medicine and science have redefined what constitutes an impairment to work, and the nature of work itself has shifted toward service and knowledge-based employment—these developments need to be reflected in agencies' eligibility and review processes.

Although Social Security is currently the largest program in the federal budget, it will soon be eclipsed by Medicare and Medicaid, which are fast growing programs in the federal budget both now and over the longer term. Many policymakers, industry experts, and medical practitioners contend that the U.S. health care system—in both the public and private sectors—is in crisis. Long-term health spending growth in Medicare and Medicaid is driven by both the aging of the population and the rapid growth of health care costs. In the private sector, employers and other private purchasers of health care services find that the soaring cost of health insurance premiums poses a threat to their competitive position in an increasingly global market.

Despite the significant share of the economy consumed by health care, a number of key U.S. health outcomes continue to lag behind other

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industrialized nations. The United States now spends over 15 percent of its gross domestic product on health care—far more than other major industrialized nations. Yet relative to these nations, the United States performs below par in such measures as rates of infant mortality, life expectancy, and premature and preventable deaths. Moreover, evidence suggests that the American people are not getting the best value for their health care dollars. Studies show that quality is uneven across the nation, with a large share of patients not receiving clinically proven, effective treatments. At the same time, access to basic health care coverage remains an elusive goal for nearly 45 million Americans without insurance, with a growing percentage of workers losing their employer-based coverage. Many more millions of Americans are underinsured or have lost some of the benefits their health plans previously afforded.

The policy process will be challenged to fundamentally rethink the design of our health care system. Defining differences between wants, needs, affordability, and sustainability will be fundamental to rethinking the design of our current health care system. Among the areas that should be on the table is how to balance responsibility for financing health care among government at all levels, employers and individuals. In the past several decades, the responsibility for financing health care at the point of delivery has shifted away from the individual patient, falling from nearly half—46 percent—of health care spending 40 years ago to 14 percent today. Tax preferences for insured individuals and their employers have also shifted some of the financial burden for private health care to all taxpayers. Tax policies permit the value of employees' health insurance premiums to be excluded from the calculation of their taxable earnings and exclude the value of the premium from the employers' calculation of payroll taxes for both themselves and employees. These tax exclusions represent a significant source of forgone federal revenue and work at cross-purposes to the goal of moderating health care spending. Health savings accounts and other consumer-directed plans, which shift more of health financing to the individual, also have been accorded various tax preferences.

Promoting consistent quality of care is another challenge facing the health care system. Public and private payers are experimenting with payment reforms designed to foster the delivery of care that is clinically proven to be effective. Ideally, identifying and rewarding efficient providers and encouraging inefficient providers to emulate best practices will result in better value for the dollars spent on care. However, implementing performance-based payment reforms, among other strategies, on a systemwide basis, will depend on system components that are not

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currently in place nationwide—such as compatible information systems to facilitate the production and dissemination of medical outcome data, safeguards to insure the privacy of electronic medical records, improved transparency through increased measurement and reporting efforts, and incentives to encourage adoption of evidence-based practices. These same system components would be required to develop medical practice standards, which could serve as the underpinning for effective medical malpractice reform while reducing costs and improving quality of care. Policymakers would need to consider the extent to which federal leadership could foster these system components.

As the foregoing suggests, the aging population will have profound implications for our policies and programs. The following kinds of questions illustrate the kinds of choices we face:

- **Social Security**—How should Social Security be reformed to provide for long-term program solvency and sustainability while also ensuring adequate benefits (for example, increase the retirement age, restructure benefits, increase taxes, and/or create individual accounts)?
- **Labor Force**—How can existing policies and programs be reformed to encourage older workers to work longer and to facilitate phased retirement approaches to employment (for example, more flexible work schedules or receiving partial pensions while continuing to work)?
- **Private Pensions**—What changes should be made to enhance the retirement income security of workers while protecting the fiscal integrity of the PBGC insurance program (for example, increasing transparency in connection with underfunded plans, strengthening pension funding rules, modifying PBGC's premium structure and insurance guarantees, or restricting benefit increases and the distribution of lump sum benefits in connection with certain underfunded plans)?
- **Disability programs**—How can federal disability programs, and their eligibility criteria, be brought into line with the current state of science, medicine, technology, and labor market conditions?
- **Health care reform**—How can we perform a systematic reexamination of our current health care system? For example, could public and private entities work jointly to establish formal reexamination processes that would (1) define and update as needed a minimum core



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of essential health care services, (2) ensure that all Americans have access to the defined minimum core services, (3) allocate responsibility for financing these services among such entities as government, employers, and individuals, and (4) provide the opportunity for individuals to obtain additional services at their discretion and cost?

- **Health care financing**—How can health care tax incentives be designed to encourage employers and employees to better control health care costs? For example, should tax preferences for health care be designed to cap the health insurance premium amount that can be excluded from an individual’s taxable income?
- **Health care quality**—How can industry standards for acceptable care be established and payment reforms be designed to bring about reductions in unwarranted medical practice variation? For example, what can or should the federal government do to promote uniform standards of practice for selected procedures and illnesses?

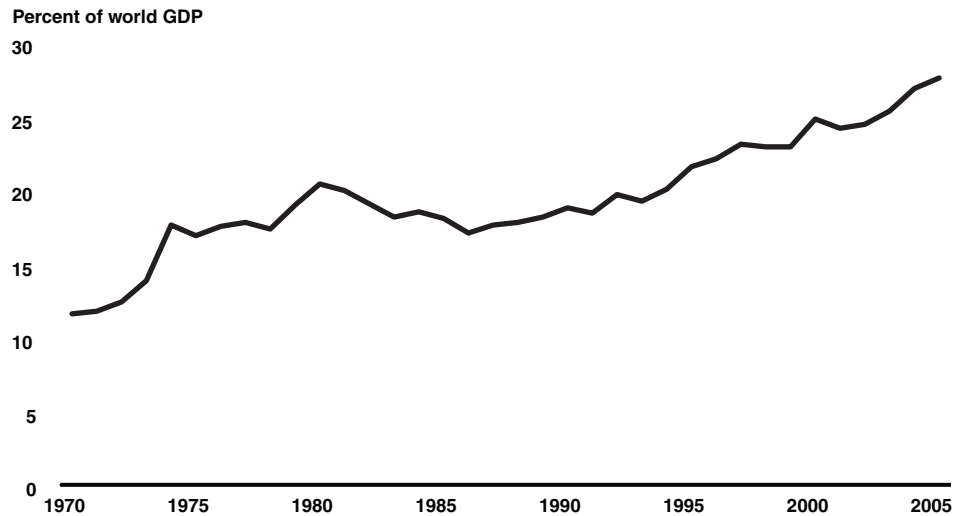
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## Increasing Global Interdependence

The rapid increase in the movement of economic and financial goods, people, and information around the world demonstrates that the nation is no longer self-contained, either in its problems or their solutions. The growing interdependence of nations—globalization—has brought clear economic and social benefits. But while the world has “gotten smaller,” it has raised new challenges for policymakers that require the nation to be involved in or respond to events outside its borders.

One measure of growing worldwide interdependence is the total share of world goods and services that is traded. As shown in figure 6, from 1970 through 2005, world exports increased from about 12 percent to about 28 percent of world GDP. Hence, all over the world, people are depending more and more on other nations to consume the goods they produce and to produce the goods they in turn consume.

**Figure 6: World Exports of Goods and Services as a Share of World GDP, 1970–2004**



Source: International Monetary Fund, World Economic Outlook Database, September 2004

In addition, the internationalization and liberalization of financial markets worldwide, along with growing wealth in many countries, have fueled huge increases in cross-border investments. Information is also moving across borders, as indicated by the rapid adoption of the use of the Internet—from 1991 through 2001 the number of Internet users increased from 4.4 million to 502 million.

Increased global interdependency and rapid technological advancement in the financial services industry pose significant challenges to U.S. regulatory institutions. The present federal financial regulatory structure evolved largely as a result of periodic ad hoc responses to crises such as financial panics. Thus the current regulatory structure includes numerous regulators that specialize in areas such as banking, securities, futures, and insurance but that have difficulty seeing the total risk across industry lines of the entities they regulate. In the last few decades, however, the financial services industry, especially as represented by the largest firms, has evolved, becoming more global, more concentrated, complex, and consolidated across sectors, and increasingly converging in terms of product offerings. Consumers are faced with an increasingly complicated array of options for managing their personal finances and selecting investments and credit products. Individuals can also invest in companies worldwide and can be defrauded or have their identities stolen from almost anywhere.

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The shift to a global economy is challenging customary federal approaches to education and employment. The global economy, advances in technology, and the availability of foreign workers, enable work to be shifted to other countries or render some U.S. jobs obsolete. If we are to compete effectively, our educational system must provide the means for adults to continue to learn new skills and enhance their existing abilities and competitive posture. As an increasingly volatile job market creates and eliminates jobs, federal programs that train new workers or support workers who lose their jobs must also be capable of responding to sudden changes in the economy. It will also be important to consider whether the number of visas allowed for both employment and education may affect long-term competitiveness, and our ability to build bridges with other nations, their people, and their cultures while also addressing our national and homeland security needs.

Global and shifting trade patterns create a range of challenges for policymakers. The high level of U.S. trade deficits, rapid increases in imports from nations such as China, and the increase in services trade have led to questions about the best way to ensure that trade is fair and contributes to the well-being of Americans. The globalization of economic activity is bringing an increasing share of the U.S. economy under the domain of international agreements. Economic activity historically viewed as isolated from international trade agreements, such as local government procurement practices, may come under the scrutiny of other parties to the trade agreements, and increasingly be subject to their enforcement machinery.

The U.S. position in the worldwide economy has fundamentally changed, and increasing globalization and the shifting of business income overseas prompts questions about the administrability and sustainability of our current income-based tax system. Furthermore, the Internal Revenue Service faces significant tax enforcement challenges. The tax gap—the difference between what taxpayers annually report and pay and what they should have reported and paid in taxes—was estimated at over \$300 billion in 2001, and IRS has been challenged in recent years to assess and collect taxes stemming from increasingly complex international business activity and transactions. The ongoing debate over tax system reform is partly about whether the tax revenues needed to fund the federal government can best be raised using the current structure, which is heavily dependent on income taxes, or a fundamentally different structure, which might include more dependence on consumption taxes. As policymakers grapple with such issues, they will have to balance multiple objectives such as economic

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growth, equity, effectiveness, simplicity, transparency, fairness, and administrability while raising the needed revenue.

As the foregoing suggests, globalization will have profound implications for our policies and programs. The following kinds of questions illustrate the kinds of choices we face:

- **Financial regulation**—Is it time to modernize our financial regulatory system by consolidating various federal regulatory agencies to promote a more coherent and integrated structure while specifying federal goals more clearly?
- **Financial literacy**—What role should the federal government take in improving financial literacy among consumers, and what are the most effective strategies for doing so?
- **Workforce retraining**—Do current workforce retraining programs provide adequate incentives to help the United States develop lifelong learning strategies and proactive training programs? Should current federally funded training programs operated across multiple federal agencies—9 federal agencies administer 44 such programs—be better integrated and restructured to increase their cost effectiveness?
- **Domestic subsidies**—Do current federal agricultural policies and programs, which largely rely on subsidies, contribute to unfair trade? In addition, do current policies remain relevant to the modern agricultural sector?
- **Tax enforcement**—How can we best strengthen enforcement of tax laws to give taxpayers confidence that their friends, neighbors, and business competitors are paying their fair share?
- **Taxation of international transactions**—Is the federal income-based tax system sustainable and administrable in a global economy? How should we tax the income of U.S. multinational corporations that is earned outside of the United States?
- **Tax system base**—To what extent should the basis of the existing system be changed from an income to a consumption base? Would such a change help respond to challenges posed by demographic, economic, and technological changes? How would reforms address such issues as

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the impact on state and local tax systems and the distribution of burden across the nation's taxpayers?

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## Promoting Economic Growth in a Knowledge-Based Society

Many of the issues facing the Congress and the nation stem from complex and evolving domestic and global economies. Ultimately, sustaining and increasing economic growth over the longer term is essential to provide resources for a smaller cohort of workers to support an aging society. The nation's shift to a knowledge-based economy has underscored the importance of science and technology for economic growth and productivity and has placed greater emphasis on public policies that rely on market forces and competition. Over the longer term, the financial burdens facing the smaller cohort of future workers in an aging society would most certainly be lessened if the economic pie were enlarged.

The move away from the nation's traditional, manufacturing-based economy toward one characterized by the production of information, knowledge and services has contributed to a resurgence of productivity growth. Labor productivity growth accelerated from 1.6 percent per year in the early 1990s to 2.9 percent per year from 1996 through 2003.

Sustaining this relatively high rate of productivity will present challenges to policymakers. Because intellectual assets are the underpinning of a knowledge-based economy, investment in human capital is fundamental to continued growth. For policymakers, this shift requires greater attention to education and training, both for children and adults. New importance will need to be given to continuing education and training for adults, whose longer life expectancies will allow them to stay in the workforce longer. The shift to a knowledge-based economy also has implications for immigration policy. The emergence of technology-oriented industries has created growing reliance on workers from other countries, working either in the United States or in their home countries. In light of heightened concern for homeland security, the flow of workers into the country is being reassessed.

Other key factors that drive sustained growth in the changing economy include research and development expenditures, trade openness, and effective public and private infrastructure. Advances in science and technology in the United States, along with the nation's strong research and development infrastructure and intellectual property protections, have long ensured the United States a leadership position in the development and commercialization of scientific advances and have helped nurture

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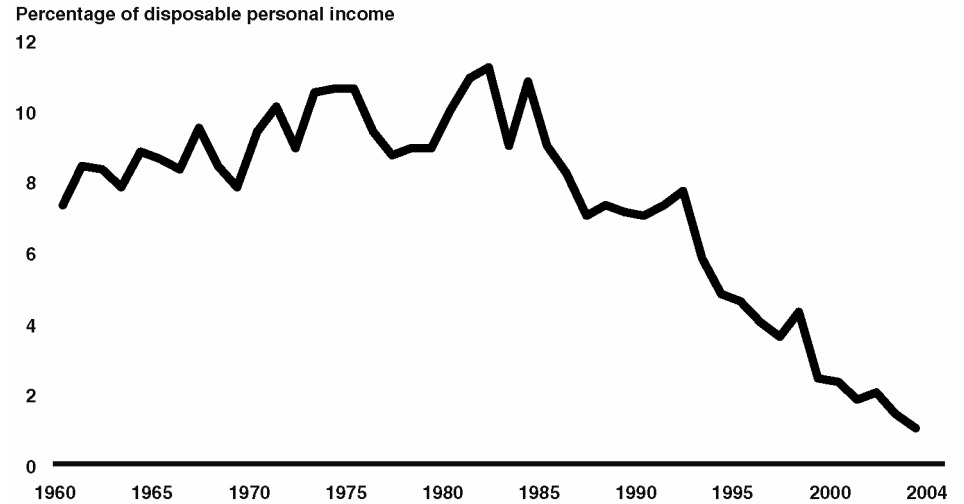
entrepreneurship and dissemination of information on new technologies. However, other nations are gaining in their research infrastructure and are beginning to challenge the preeminent position of the United States, challenging policymakers to further stimulate greater private research and collaborative scientific initiatives. Information technology advancements have contributed to substantial gains in U.S. productivity, but interconnectivity has also raised the potential for unauthorized access to personal and confidential data and created new vulnerabilities to the nation's critical operations and the infrastructures they support.

Effective public infrastructure is also an important underpinning for long-term growth. Increasing passenger and freight travel has led to growing congestion, and policymakers face the challenge of promoting more integrated, intermodal transportation systems. Transcending the boundaries of levels of government, as well as separate funding streams for different modes, will be essential if we are going to provide efficient movement of goods and people for a 21<sup>st</sup> century economy.

Underlying land use planning practices can both reflect transportation policies as well as further exacerbate mobility challenges. Specifically, sprawling development places undue stress on transportation systems, as well as on energy, water, and the environment. In many parts of the country, water shortages are expected over the next 10 years, which will necessitate difficult tradeoffs between competing claimants for this increasingly scarce resource.

The sustainability of economic growth and higher productivity levels also depend in large part on our national saving. Saving and investment drive the productivity growth that allows personal incomes to rise without accelerating inflation. However, national saving remains at both historically and comparably low levels. Historically, the most direct way for the federal government to increase saving has been to reduce the deficit (or run a surplus). Although the government may try to increase personal saving, results of these efforts have been mixed. For example, even with the preferential tax treatment granted since the 1970s to encourage retirement saving, the personal saving rate has generally steadily declined. (See fig. 7.)

**Figure 7: Personal Saving Rate Has Steadily Declined**



Source: Bureau of Economic Analysis.

In recent years, personal saving by households has reached record lows, while at the same time the federal budget deficit has climbed. Accordingly, national saving has plummeted, but the economy has continued to grow, in part because more and better investments were made. That is, each dollar saved bought more investment goods, and a greater share of saving was invested in highly productive information technology. The economy has also continued to grow because the United States was able to invest more than it saved by borrowing abroad, that is, by running a current account deficit. However, a portion of the income generated by foreign-owned assets in the United States must be paid to foreign lenders. National saving is the only way a country can have its capital and own it too.

The persistent U.S. current account deficits of recent years have translated into a rising level of indebtedness to other countries. However, many other nations currently financing investment in the United States also will face aging populations and declining national saving, so relying on foreign savings to finance a large share of U.S. domestic investment or federal borrowing is not a viable strategy for the long run.

The foregoing suggests that changing economic trends and related forces will have important implications for federal policies and activities, as illustrated by the following questions:

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- **Immigration and workforce**—How can the United States balance immigration policies, such as worker and student visa programs, to address the need for workers with technical skills and the nation’s need to maintain global preeminence in higher education, science and emerging homeland security requirements?
  - **Research and development**—Are different kinds of federal incentives needed to encourage greater private sector collaboration and nurture interdisciplinary research and development? For example, to what extent does the current research tax credit actually stimulate private sector research spending that would not have occurred otherwise?
  - **Transportation**—Do the existing tools and delivery mechanisms, such as existing trust funds dedicated to certain modes of transportation, have the ability to provide intermodal, efficient, cost-effective solutions to mobility and security challenges?
  - **Land use planning**—Can alternative federal approaches to transportation, land management and water policies be adjusted to better promote sustainable management of our nation’s land and water resources? For example, given projected water supply shortages, is there a need to reassess the balance between urban expansion in water-scarce regions and the continuance of existing crop irrigation practices?
  - **Personal savings**—Could the myriad savings incentives (for example, IRA’s, health savings accounts, education savings incentives, etc.) that complicate the current tax system be consolidated and simplified while promoting increased savings?

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## Changing Security Threats

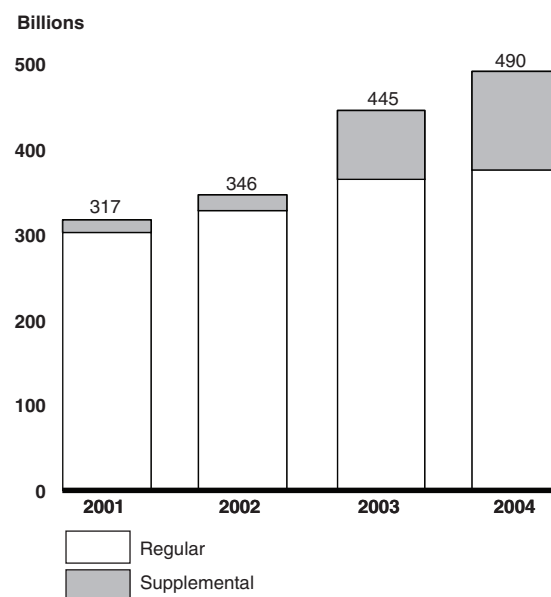
The United States is militarily unchallenged and probably will be for the foreseeable future. Since the demise of the Soviet Union and the end of the Cold War, the United States has emerged as the dominant military, political and economic power in the world. Yet in the past 15 years, the world has experienced dramatic changes in the overall security environment. The focus has shifted from conventional threats posed during the Cold War era to more unconventional and asymmetric threats which take advantage of the individual freedoms we enjoy, as evidenced in the events of September 11, 2001.

In response to these changing threats, the Congress has taken a number of steps including (1) increased funding for the Department of Defense (DOD)



(See fig. 8.), (2) created the Department of Homeland Security (DHS), (3) provided increased funding for DHS and other federal agencies responsible for domestic homeland security, notably for border and transportation security, and (4) restructured intelligence activities. The Congress faces the difficult task of integrating and balancing fighting terrorism abroad and meeting the requirements for homeland security with other domestic priorities all the while protecting American liberties.

**Figure 8: Growth in Budget Authority for Department of Defense Fiscal Years 2001-2004**



Source: Office of Management and Budget, Budget of the United States Government, Fiscal Year 2006(February 2005).

Note: Supplementals are for defense and other global war on terror.

While DOD has taken steps to meet short term operational needs, it still faces the fundamental challenge of determining how it will meet the longer term concerns of reorganizing its forces and identifying the capabilities it will need to protect the country from current, emerging, and future conventional and unconventional security threats. As DOD seeks to meet the demands of the new security environment, it continues to bear the costs of the past by maintaining or continuing to pursue many of the programs and practices from the Cold War era. Moreover, DOD faces serious and long-standing challenges in managing its ongoing business operations. Complicating its efforts are numerous systems problems and a

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range of other long-standing weaknesses in the key business areas of strategic planning and budgeting, human capital management, infrastructure, supply chain management, financial management, information technology, weapon systems acquisition, and contracting. In fact, DOD alone has 8 of the 25 items and shares in the 6 cross-cutting ones on our recently-issued high-risk list.

Concerns about the affordability and sustainability of the rate of growth in defense spending will likely prompt decision makers to reexamine fundamental aspects of the nation's security programs, such as how DOD plans and budgets; organizes, manages, and positions its forces; acquires new capabilities; and considers alternatives to past approaches. To successfully carry out this reexamination, DOD must overcome cultural resistance to change and the inertia of various organizations, policies, and practices that became well rooted in the Cold War era.

The threat of terrorism will persist well into the 21<sup>st</sup> century. Terrorists are dispersed in loosely organized, self-financed, international networks, some of which are cross-national. Domestic terrorist groups remain a security threat, though currently to a much lesser extent than the international terrorist movement. We must fundamentally reexamine our approaches to terrorism and homeland security—the nature of the terrorist threat, its long-term impact, and the impact of our strategies. While most believe we are safer than we were on the day of the September 11 attacks, we still are not safe. As the Gilmore and 9/11 Commissions pointed out, the nation will never be completely safe and total security is an unachievable goal.

To adapt national strategies to address current and future threats to homeland security, it will be imperative to define an acceptable, achievable, and affordable level of risk. Security risks have been exposed in many aspects of normal life, with perhaps many of the greatest dangers posed in areas that Americans have simply taken for granted, such as air and water supplies, food production chains, information systems, airports and train stations, ports, borders, and shopping malls. However, we cannot afford to protect everything against all threats—choices must be made about protection priorities given the risk and how to best allocate available resources. While risk-based allocation decision making is still evolving, we must take a more systematic, reasonable and responsible approach to allocating resources.

Another crucial challenge to addressing security risks across the nation is establishing effective federal, state, and local government; private sector;

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nongovernmental; and nation-state partnerships. The Constitution requires the federal government to “provide for the common defense” and to “repel invasions.” Many would interpret those requirements to justify homeland security and related counterterrorism activities as an inherently governmental obligation. However, the vast majority of the targets that require protection are those owned by the private sector—critical infrastructure such as water and power sources and information systems. In addition, many of the emergency response and recovery capabilities are those with nonfederal or not-for-profit entities, such as public health facilities. Thus homeland security can only be accomplished through recognizing the interdependencies of federal, state, local, and private sector partners and the careful planning and integration of the roles and responsibilities of federal and nonfederal partners. For example, emergency response to a terrorist attack involving chemical or biological weapons will require effective coordination between federal, state, and local law enforcement agencies; other first responders; as well as public health agencies, affected hospitals, and laboratories. The challenge for the federal government is to design, select, and manage the various tools to encourage cost-effective integration to fully leverage scarce resources. For example, ensuring that critical information is shared, analyzed, integrated, and disseminated can help prevent or minimize terrorist activities.

The following questions illustrate the kinds of issues that we will face as the nation adapts to the changing threats to our national and homeland security.

- **Defense resource allocation**—How should the historical allocation of resources across services and programs be changed to reflect the results of a forward-looking comprehensive threat/risk assessment as part of DOD’s capabilities-based approach to determining defense needs?
- **Defense support services**—What kinds of economies of scale and improvements in delivery of support services would result from combining, realigning, or otherwise changing selected support functions (e.g., combat support, training, logistics, procurement, infrastructure, or health care delivery)?
- **Homeland security risk**—What is an acceptable level of risk to guide homeland security strategies and funding?

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- **Critical infrastructure**—Are existing incentives and initiatives sufficient to support private sector protection of critical infrastructure they own, and what changes might be necessary? What cybersecurity technology can be applied to protect critical infrastructure from attack?
  - **Information sharing**—How can intelligence and information on threats be shared with other levels of government and other critical entities, yet be held secure?

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## Governance Challenges

The government's capacity to address these trends and challenges is, itself, a 21<sup>st</sup> century challenge. The capacity of the system to address the emerging issues identified in these themes is predicated on a policymaking and management process that has sufficient foresight, information, integration, and management capacity to fully consider and act on emerging trends.

In part this is a question of time horizons. Policy action, or inaction, has implications far beyond today. How can policymaking institutions develop the capacity to consider the implications of actions or inaction for current as well as future generations? A longer-term perspective may be essential to keeping ahead of the "crisis curve," but it can also offer other benefits. If the time horizon for policy debates recognized longer-term forces, it would be easier for leaders to make the case for change to the broader public since it permits changes to be phased in over many years.

Whether it be future labor force trends or long-term health care costs, policymakers will need far better performance and cost information as they take on such broad-ranging issues. To continue to be a leading democracy in the information age may very well mean producing unique public sources of objective, independent, scientifically grounded, and widely shared quality information so that we know where the United States stands now and what the trends are on both absolute and relative bases—including comparisons with other nations. By ensuring that the best facts are made more accessible and usable by the many different members of our society, we increase the probability of well-framed questions and debates along with effective solutions. The stakes are high, including considerations regarding allocating scarce public resources, strengthening the economy, creating jobs, stimulating future industries, enhancing security, promoting safety, protecting privacy, strengthening our competitive edge, and sustaining the environment.

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Addressing newly emergent issues and transformational change calls for a policy process that can look at broader issues across the narrow confines of individual programs, agencies, and tools. Many emerging issues are cross-cutting in nature and the policy process will have to be comprehensive enough to address these new tradeoffs. However, federal programs remain highly fragmented, reflecting a policymaking process that is overly stovepiped by agency and program, with insufficient focus on how individual programs contribute to overarching, crosscutting goals and missions. Although these individual programs address common or similar performance goals, they result in an overly fragmented delivery network and at times work at cross purposes. For example, federal food safety programs are carried out by 12 agencies with differing enforcement criteria and inspection practices. The Government Performance and Results Act (GPRA) provided for a governmentwide performance plan to address these crosscutting issues, but this plan has not yet been developed by the executive branch.

Many emerging problems span boundaries to involve federal, state, and local governments as well as private for profit and nonprofit entities. Whether it be homeland security or health care delivery, federal agencies and programs are increasingly reliant on coalitions of third-party providers, such as states, to address challenges. Moreover, such coalitions increasingly span national boundaries as many problems and issues are framed by international treaties and multilateral organizations. Often, a national, rather than strictly federal, solution is necessary requiring partnerships and concerted effort across sectors. Notwithstanding this increasing interdependence, major tensions exist as each actor in the network makes decisions with insufficient dialogue with program partners.

The foregoing suggests that public management systems and networks will have to undergo fundamental changes to respond effectively to the daunting challenges facing us. This calls for nothing less than a transformation in the people, processes, and technology used to address public goals and objectives. While some agencies are making major strides to transform their operations, in many cases the government is still trying to do business in ways that are based on conditions, priorities, and approaches that existed decades ago and are not well suited to addressing 21<sup>st</sup> century challenges.

For example, in many cases the government has not transformed how it motivates and compensates its employees to achieve maximum results within available resources and existing authorities. Even though people are

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critical to any agency's successful transformation, define its culture, develop its knowledge, and are its most important asset, a number of agencies still try to manage their people through an outmoded system that (1) rewards length of service rather than individual skills, knowledge and performance; (2) automatically provides across-the-board annual pay increases, even to poor performers; and (3) compensates employees living in various localities without adequately considering the local labor market rates for these employees. To address these problems and provide the services the public expects, the federal civil service system must be reformed governmentwide, and this reform must be guided by a set of consistent principles, criteria, and practices.

Another example is the outmoded physical footprint of agencies, which reflects the failure to take advantage of opportunities provided by new technology and transportation to modernize operations. More than 30 federal agencies control about \$328 billion in real property assets worldwide, and maintain a "brick and mortar" buildings and/or office presence in 11 regions across the nation. But this organization and infrastructure reflects a business model and the technological and transportation environment of the 1950s. Many of these assets and organizational structures are no longer needed; others are not effectively aligned with, or responsive to, agencies' changing missions; and many others are in an alarming state of deterioration, potentially costing taxpayers tens of billions of dollars to restore and repair. The Congress and several agencies have recognized and begun to address this issue, but this financial liability still looms.

The following questions illustrate the kinds of issues that we will face in better aligning our governance system with the emerging challenges posed by broad sweeping changes:

- **National performance indicators**—Is the federal government effectively informed by a key national indicator system about the position and progress of the nation as a whole—both on absolute and relative bases compared to other nations—as a guide to helping set federal agency and program goals and priorities?
- **Crosscutting program integration**—How can agencies partner or integrate their activities in new ways, especially with each other? For example, how can the myriad federal food safety programs managed across several federal agencies be consolidated to better promote safety and the integrity of the nation's food supply?

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- **Improving partnerships**—What mechanisms might usefully bring together leaders across governments to address joint problems, perhaps through establishing commissions or other vehicles for promoting dialogue and action?
  - **Federal human capital reform**—How should the federal government update its classification and compensation systems to be more flexible, market-based and performance-oriented while at the same time incorporating safeguards to help ensure consistency and equity and prevent abuse of employees?
  - **Modernizing the federal footprint**—In a modern society with advanced telecommunications and electronic information capabilities, does the government still need 11 regions? What opportunities exist to more strategically manage the federal government’s real property assets, such as disposing of excess federal facilities to make the federal portfolio more relevant to current missions and less costly?
  - **Transformational leadership**—Should we create chief operating officer or chief management officer positions with term appointments within selected agencies to elevate, integrate, and institutionalize responsibility and authority for business management and related transformation efforts?

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## Where Do We Go From Here?

We recognize that the process of reexamining the base of government will not be a simple or easy process—there are no “quick fixes.” Such a process reverses the focus that occurs in incremental reviews, where disproportionate scrutiny is given to proposals for new programs or activities but little or no scrutiny is given to those that are already in the base. Taking a hard look at existing programs and carefully reconsidering their goals and their financing is a challenging task. Reforming programs and activities leads to winners and losers. Given prior experience and political tendencies, there is little real “low-hanging fruit.”

The size of the fiscal challenge and the significance of the societal and economic changes worldwide means this kind of examination and the hard choices necessary to restore a sustainable fiscal path and modernize government may take a generation to address. Our history suggests that all major spending and revenue programs and policies need to be subject to periodic reviews; exempting major areas can undermine the credibility and support for the entire process.

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Beginning the reexamination and review process now would enable decision makers to be more strategic and selective in choosing areas for review over a period of years. Reexamining selected parts of the budget base over time rather than all at once will lengthen the process, but it may also make the process more feasible and less burdensome for decision makers. And by phasing in changes to programs or policies that might otherwise have prohibitively high transition costs, the impact can be spread out over longer time periods. After all, our country, children, and grandchildren are counting on us to be both prudent today and effective stewards for tomorrow. We should not be satisfied with anything less.

Although reexamination is never easy, the effort is not without precedent. The federal government, in fact, has reexamined some of its programs and priorities episodically in the past. Programmatic reexaminations have included, for example, the 1983 Social Security reform, the 1986 tax reform, and the 1996 welfare reform. They have also included reforms such as the creation of the Department of Homeland Security and, most recently, the ongoing reorganization of the U.S. intelligence community, as this Committee knows so well. From a broader fiscal standpoint, the 1990s featured significant deficit-reduction measures adopted by the Congress and supported by the President that made important changes to discretionary spending, entitlement program growth, and revenues that helped eliminate deficits and bring about budgetary surpluses. States and other nations also have engaged in comprehensive reexamination exercises.

In our system, a successful reexamination process will in all likelihood rely on multiple approaches over a period of years. The reauthorization, appropriations, oversight, and budget processes have all been used to review existing programs and policies. Adding other specific approaches and processes—such as temporary commissions or executive reorganizations to develop policy alternatives—has been proposed. We would suggest that there is no single approach or institutional reform that can address the myriad of questions and program areas that need to be revisited.

Fortunately, GPRA and other results-oriented management laws enacted over the last 12 years have built a base of performance information that can assist the Congress and the President in this effort. In the last few years, OMB has been working to rate the effectiveness of programs under the program assessment rating tool (PART). There are also many nongovernmental sources of program evaluation and analysis. And, finally,



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the Congress has its own analytic support—your staff and that of the congressional support agencies, including GAO. As always, GAO stands ready to assist the Congress as it develops its agenda and to help answer any of the questions the Congress wishes to pursue.

We hope that this new report will be used by various congressional committees as they consider which areas of government need particular attention and reconsideration, recognizing that while answers to these questions may draw on the work of GAO and others, only elected officials can and should decide whether, how, and when to move forward.

Chairman Collins, Senator Lieberman, and Members of the Committee this concludes my testimony. I would be happy to answer any questions you may have.

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