S. HRG. 110–285

Senate Hearings

Before the Committee on Appropriations

Financial Services and General Government Appropriations

Fiscal Year 2008

110*th* CONGRESS, FIRST SESSION

H.R. 2829

COMMODITY FUTURES TRADING COMMISSION
DEPARTMENT OF THE TREASURY
DISTRICT OF COLUMBIA
FEDERAL DEPOSIT INSURANCE CORPORATION
NONDEPARTMENTAL WITNESS
OFFICE OF MANAGEMENT AND BUDGET
SECURITIES AND EXCHANGE COMMISSION
SMALL BUSINESS ADMINISTRATION
THE JUDICIARY

Financial Services and General Government Appropriations, 2008 (H.R. 2829)

S. HRG. 110–285

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON APPROPRIATIONS

UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

H.R. 2829

AN ACT MAKING APPROPRIATIONS FOR FINANCIAL SERVICES AND GENERAL GOVERNMENT FOR THE FISCAL YEAR ENDING SEPTEMBER 30, 2008, AND FOR OTHER PURPOSES

Commodity Futures Trading Commission
Department of the Treasury
District of Columbia
Federal Deposit Insurance Corporation
Nondepartmental witness
Office of Management and Budget
Securities and Exchange Commission
Small Business Administration
The judiciary

Printed for the use of the Committee on Appropriations

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U.S. GOVERNMENT PRINTING OFFICE

33–917 PDF WASHINGTON : 2008

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FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

FRIDAY, MARCH 9, 2007

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 8:50 a.m., in room SD–138, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Bond, and Allard.

COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF HON. REUBEN JEFFERY III, CHAIRMAN

ACCOMPANIED BY:
MIKE DUNN, COMMISSIONER
WALT LUKKEN, COMMISSIONER

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good morning and welcome. I'm going to start a few minutes early, which is totally atypical of Capitol Hill but it's an indication of the fact that we are going to have a rollcall vote at about 9:30 and I have a dual responsibility of chairing this important subcommittee and serving as majority whip on the floor. So I'll have to be there right as the rollcall begins and we'll have to interrupt this hearing for a brief time, as two votes are taken. So I apologize to those who may be a little bit surprised by a 10-minute earlier start but I hope that we can get this underway, make some progress, break for the votes and return and conclude.

I'm pleased to welcome those who are in attendance to the first in a series of public hearings we're going to conduct to consider the funding requests of several of the dozens of Federal agencies within the jurisdiction of this new Appropriations Subcommittee on Financial Services and General Government.

I appreciate the willingness of those who are in attendance to accommodate their scheduling to the date, time, and location. I'm glad you're all here. I welcome my colleagues who will join me, I'm sure, as the subcommittee hearing is underway. This morning, we will be hearing from two distinguished panels of witnesses.

First, I'm pleased to welcome Chairman Reuben Jeffery of the Commodity Futures Trading Commission (CFTC). I believe Commissioner Mike Dunn is here. I don't know if Mr. Lukken is in attendance at this point but he may join us a little later.

Our second panel will feature testimony from Steven Preston, Administrator of the Small Business Administration (SBA). To a casual administrator, these two agencies may seem quite dissimilar and oddly matched. Certainly their assigned missions and obligations are distinctive yet both of these agencies occupy pivotal positions at the forefront of stimulating economic growth in our country.

The Commodity Futures Trading Commission, created in 1974, is responsible for fostering the economic utility of futures markets by encouraging their competitiveness and efficiency, their integrity and protecting market participants against manipulation, abusive trade practices and fraud. That oversight and enforcement mission becomes tangible when you consider that the prices established by the futures market directly or indirectly affect the lives of all of us. Futures prices impact the prices we pay for necessities of life—our food, clothing, shelter, fuel for vehicles, and heat in our homes. Moreover, since the agency's inception, there has been a remarkable transformation in this futures industry. Thirty years ago, the vast majority of trading occurred in the agricultural sector. Today, novel, highly complex financial contracts based on such things as foreign currency, interest rates, Treasury bonds, weather, real estate, economic derivatives, stock market indices—the list goes on. But that list has gone far beyond the original mission of agricultural contracts.

Financial derivatives now comprise approximately 82 percent of all exchanged derivative activity, 8 percent for agriculture. Ever expanding complexities pose ever demanding challenges. I'm proud to have the two largest futures exchanges in the United States, the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CMBOT) headquartered in Illinois and one of CFTC's three regional offices located there as well. These exchanges recently set an all-time total daily trading volume record of 24,915,515 contracts cleared through CME, CMBOT Clearing Agreement.

The President's budget proposes $116 million in funding for the CFTC for the next fiscal year. This sum represents a hike of 18 percent over the $98 million provided for fiscal year 2007 under our continuing resolution. It is 9 percent below the $127 million level the President sought in fiscal year 2007.

Now the Small Business Administration will follow after the CFTC. It was established in 1953. We know its general mission to promote and protect the viability of America's entrepreneurs, innovators, and small business owners. In my home State of Illinois, the contributions of the estimated 1,087,700 small businesses are critical to our economy, creating over 2.6 million jobs in my State. Our Nation depends on the SBA to ensure that capital assistance is available for those who need it the most.

Like the CFTC, the SBA has experienced dramatic growth in the programs it offers. SBA's programs now include financial and Federal procurement, management assistance, specialized outreach to women, minorities, and Armed Forces veterans.

For the Small Business Administration, the President seeks $464 million in new budget authority for the next fiscal year. No new budget authority is requested for disaster loan programs, since there are sufficient carryover balances to operate them. The

amount requested is a reduction from the last fiscal year's continuing resolution of $108 million. This can be attributed to the fact that funding was provided in that continuing resolution for disaster loan administrative expenses and no new funds are requested for that purpose.

There are many questions that I will raise about the SBA as we get into it, particularly about the microloan program but in the interest of moving this forward, I would like at this point to introduce Chairman Jeffery and welcome him to this new subcommittee of Appropriations, the first inaugural hearing and say that the floor is yours and I'd invite you to proceed with your testimony.

STATEMENT OF CHAIRMAN JEFFERY

Mr. JEFFERY. Thank you very much, Mr. Chairman. It's an honor to be here today to testify on behalf of the Commodity Futures Trading Commission. Today, I'd like to discuss the impact of the commodity futures and options industry on the everyday lives of Americans, the mission and program responsibilities of the agency and finally, our fiscal year 2008 justification for the $116 million funding level requested by the administration.

This proposed funding level will enable the Commission to address two major needs: staff increases and technology investment.

During the past 10 years, as can be seen in figure 1 on the screen to my left, trading volume on U.S. futures exchanges has quintupled. Today, in a single day of trading, markets will move more than $5 trillion of notional value. The industry, as you, Mr. Chairman, correctly and very eloquently pointed out, has grown from largely agricultural product hedging risks to a broad array of complex products related to both physical commodities and financial instruments.

At the same time, however, Commission staffing levels have fallen to 458 full-time employees. This compares with 497 employees in 1976, the Commission's first full year of operation. Commission employees work hard. They work smart and they use technology effectively. But they are severely stretched.

While the daily business of CFTC can appear from the outside looking in to be somewhat obscure and highly technical in nature, the mission of the agency is quite clear and two-fold: First, to protect the public and market users from manipulation, fraud and abusive practices and second, to promote open, competitive and financially sound markets for commodity futures.

This is important because the futures markets are used in the price discovery process, affecting the price of a bushel of wheat, the cost of a gallon of gas, the interest rate on a student loan. If the futures markets fail to function properly, all consumers are affected.

The CFTC is the sole Federal regulator responsible for overseeing these futures markets. Through effective oversight, the CFTC enables the futures markets to better serve their vital function in the Nation's economy, providing an effective marketplace for price discovery and risk management.

RECORD GROWTH IN FUTURES INDUSTRY

To achieve these goals, the Commission employs a well-trained and dedicated staff who work within three major programmatic areas: market oversight, clearing and intermediary oversight, and enforcement. Market oversight ensures that the markets are operating efficiently and without manipulation and fraud. One workload indicator is the number of actively traded contract types on U.S. exchanges. As can be seen in figure 2, the number has more than quintupled in the past decade, with particularly significant growth seen in the last 5 years. In fact, by next year, the number of actively traded contracts is anticipated to climb to nearly 1,600, a record high. There is every indication that this significant growth in new and novel products will continue.

The CFTC must maintain a sufficient level of specialized expertise to review and analyze a very diverse group of instruments and products to ensure that they are economically viable and not susceptible to manipulation.

Clearing and intermediary oversight ensures the financial integrity of transactions on the futures markets. The CFTC oversees the principle clearing operations associated with the major commodity exchanges in Chicago, in Kansas City, and in New York. And the agency oversees market intermediaries, including some 200 futures commissions merchants, the ranks of which include banks and broker dealers with specialized futures and commodities operations as well as stand-alone futures trading houses.

Figure 3 shows that the amount of customer funds held by futures commissions merchants in segregated accounts has quadrupled over the past decade, meaning that more and more Americans are investing in the futures markets, either directly or indirectly through their participation in pension funds, mutual funds, or other institutions.

ENFORCEMENT

Turning to enforcement, this is an area in which the CFTC takes great pride. The CFTC polices the markets through strong enforcement, going after unscrupulous firms and individuals, both on and off exchange. Manipulation, fraud, and other violations undermine the integrity of the market and confidence of market participants.

Figure 4 has some statistics related to the Commission's recent enforcement activity in the areas of foreign currency and energy over the past 5 years. In the FX markets, 93 cases have been filed resulting in judgments approximating $500 million. In the energy area, the CFTC has brought 35 cases resulting in over $300 million of civil sanctions.

With the demand for enforcement resources, however, exceeding capacity, the CFTC must make hard choices every day on how to prioritize scarce investigative and litigation efforts.

INCREASED FUNDING FOR AGENCY

We are grateful for the administration's recognition of the need for increased funding for the agency. The 2008 President's budget request as depicted in figure 5, is for an appropriation of $116 mil-

lion and 475 employees—an increase of approximately $18 million and 17 people over the fiscal year 2007 continuing resolution level.

Specifically, compared to 2007, the key changes in the 2008 budget are roughly $3 million to provide increased compensation and benefit costs for the existing staff of 458, another $3 million to cover the salary and benefits related to the 17 additional full-time employees and $12 million for increased operating costs associated with information technology modernization, lease-hold expenses and other services.

This funding increase provides the Commission with the financial wherewithal to hire additional staff and to invest in technology. In staffing, the CFTC must compete for talent not only with the private sector but also with other financial regulators. Four years ago, the Congress improved the CFTC's ability to compete, granting the agency comparable pay authority with other financial agencies, so-called pay parity through Federal Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). For this authorization, which leveled the compensation playing field, all of us at the CFTC are deeply grateful. It's been a huge help. However, the agency has not yet been fully funded to the level of comparable FIRREA agencies.

Second to human capital, technology is the single most effective tool in assisting those professionals who oversee the markets. Budgetary constraints have required the Commission over several years to put new systems development initiatives and hardware and software investment on hold, as indicated in figure 6. That's not a trend of which we are particularly proud.

CFTC analysts rely primarily on two proprietary computer systems for visibility into the markets. One gives us the ability to see who is trading in the markets and who is building leverage in the market or becoming a large trader, thus developing a position that may influence market conditions. The second allows us to pull in all transactional data from traditional exchanges to identify trading patterns that might be indicative of inappropriate or manipulative trading activity.

These two systems are unique in their ability to provide transparency into cross-market trading activity across all futures markets under the Commission's jurisdiction. Their importance to ensuring market integrity cannot be overstated.

PREPARED STATEMENT

In conclusion, all of us at the CFTC take great pride in our work. I can assure you that we are working diligently and efficiently to fulfill the important responsibilities with which the Congress and the American people have entrusted us. Thank you again for the opportunity to appear before you today on behalf of the agency and I'd be happy to attempt to answer any questions that you might have.

[The statement follows:]

PREPARED STATEMENT OF REUBEN JEFFERY III

Thank you, Mr. Chairman and members of the subcommittee. I am pleased to be here to testify before you on behalf of the Commodity Futures Trading Commission, and I appreciate the opportunity to discuss issues related to the Commission's 2008 budget request.

Today I would like to discuss the impact of the commodity futures and options industry on the everyday lives of Americans, the mission and program responsibilities of the agency and, finally, our fiscal year 2008 congressional justification for the $116 million funding level requested by the administration. This proposed funding level will enable the Commission to address its two major needs—staff increases and technology investment.

During the past 10 years, as can be seen in figure 1, trading volume on U.S. futures exchanges has quintupled. Today, in a single day of trading, our markets will move more than $5 trillion. The industry has grown from largely agricultural product hedging to a broad array of complex instruments related to both physical commodities and financial instruments. Trading volume, measured by numbers of contracts traded, has more than tripled in just the past 6 years. At the same time, Commission staffing levels have fallen to 458 full-time employees. This compares with the 497 FTEs 30 years ago in 1976—the Commission's first year of operation. Commission employees work hard, work smart, and use technology effectively, but given the complexity of the markets we oversee, they are stretched.

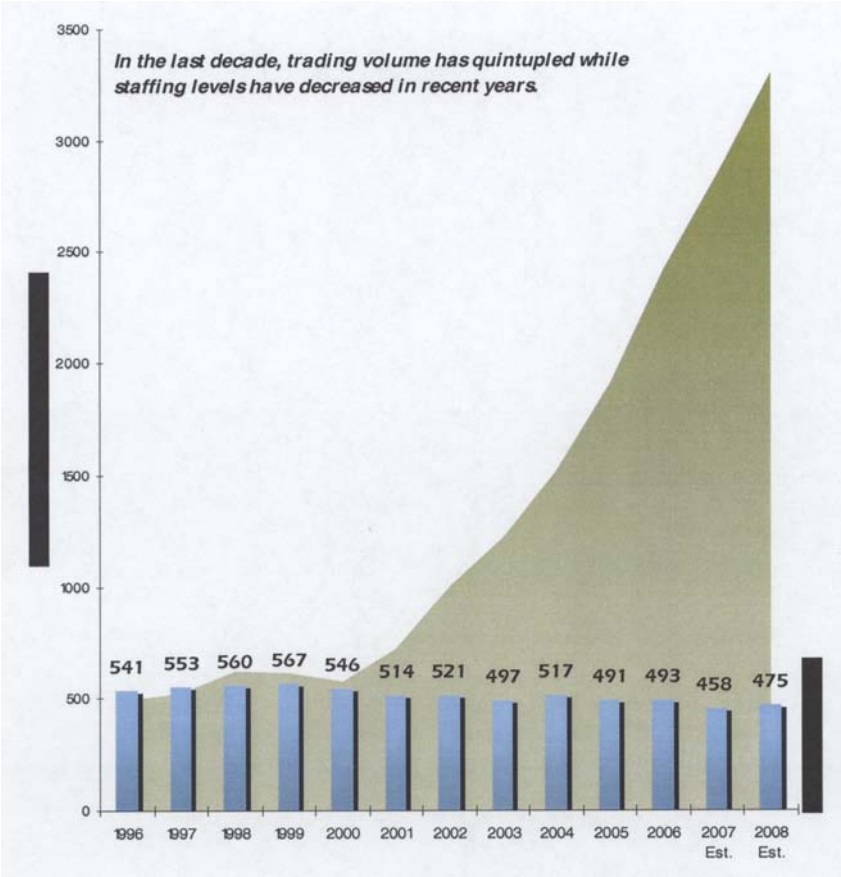


FIGURE 1.—*Growth of Volume of Contracts Traded and FTEs*

MISSION OF THE AGENCY

While the daily business of the CFTC can appear from the outside looking in to be somewhat obscure and highly technical in nature, the mission of the agency is very clear: (1) to protect the public and market users from manipulation, fraud, and abusive practices and (2) to promote open, competitive and financially sound markets for commodity futures. This is important because the futures markets are used

in the price discovery process affecting the price of a bushel of wheat, the cost of a gallon of gas, and the interest rate on a student loan. If the futures markets fail to work properly all consumers are impacted.

Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The Commission's mandate has been periodically renewed since then. In December 2000, Congress reauthorized the Commission through fiscal year 2005 with passage of the Commodity Futures Modernization Act of 2000 (CFMA).

COMMISSION STRUCTURE

The CFTC is the sole Federal regulator responsible for overseeing the futures markets by encouraging competitiveness and efficiency, ensuring market integrity, and protecting market participants against manipulation, abusive trading practices and fraud. Through effective oversight, the CFTC enables the commodity futures markets better to serve their vital function in the Nation's economy—providing an effective marketplace for price discovery and risk management.

To achieve these goals, the Commission employs a well-trained and dedicated staff who work within three major programs—market oversight, clearing and intermediary oversight, and enforcement.

Market Oversight

Market oversight ensures that the markets are operating efficiently and without manipulation and fraud. One workload indicator is the number of actively traded contracts trading on U.S. exchanges. As can be seen in figure 2, the number has more than quintupled in the last decade, with particularly significant growth seen in the last 5 years, or since the passage of the CFMA. Prior to 2000, the number of contract types traded was relatively stable at a level of around 250. By next year in fiscal year 2008, the number of actively traded contracts is anticipated to climb to nearly 1,600, a record high. There is every indication that this significant growth in new and novel products will continue.

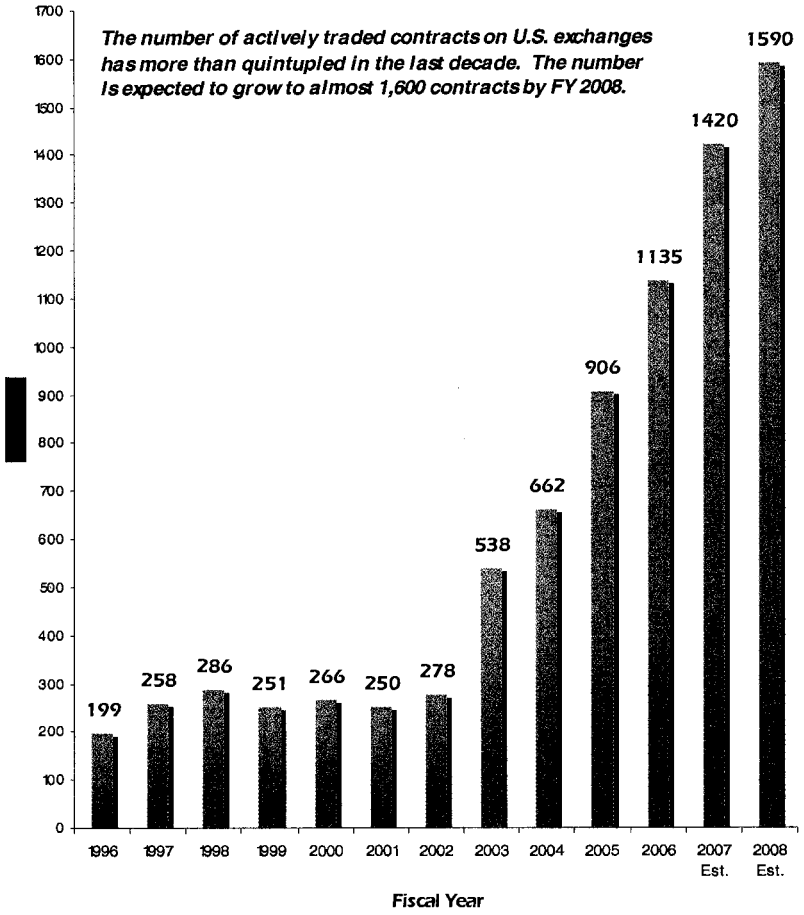


FIGURE 2.—*CFTC Actively Traded Contracts*

The CFTC must maintain a sufficient level of specialized expertise to review and analyze a very diverse group of instruments and products to ensure that they are economically viable and not susceptible to manipulation. The types of new products run the gamut from traditional commodity areas, such as new agricultural and energy futures, to novel financial derivatives based on credit risk, weather-related occurrences and effects, pollution allowances, real estate, and instruments having characteristics of both securities and commodities. Our analysts employ various methods to ensure an understanding of how the markets are functioning to develop a flexible, effective regulatory response to market conditions.

Clearing and Intermediary Oversight

Clearing and intermediary oversight ensures the financial integrity of all transactions on the markets that we regulate. The work of the staff is to ensure that the intermediaries managing these funds are properly registered, perform appropriate recordkeeping, have adequate capital, employ fair sales practices, and fully protect the funds their customers invest. The principal clearing operations are associated with the major commodity exchanges in New York, Chicago and Kansas City. Intermediaries overseen by the CFTC include some 200 futures commission merchants, the ranks of which include banks and broker-dealers with specialized futures operations, as well as stand alone futures trading houses.

In figure 3, one can observe that the amount of customer funds held by futures commission merchants has quadrupled over the past decade—meaning more and more Americans are investing in futures markets directly or indirectly through their participation in pension funds, mutual funds, and other institutions.

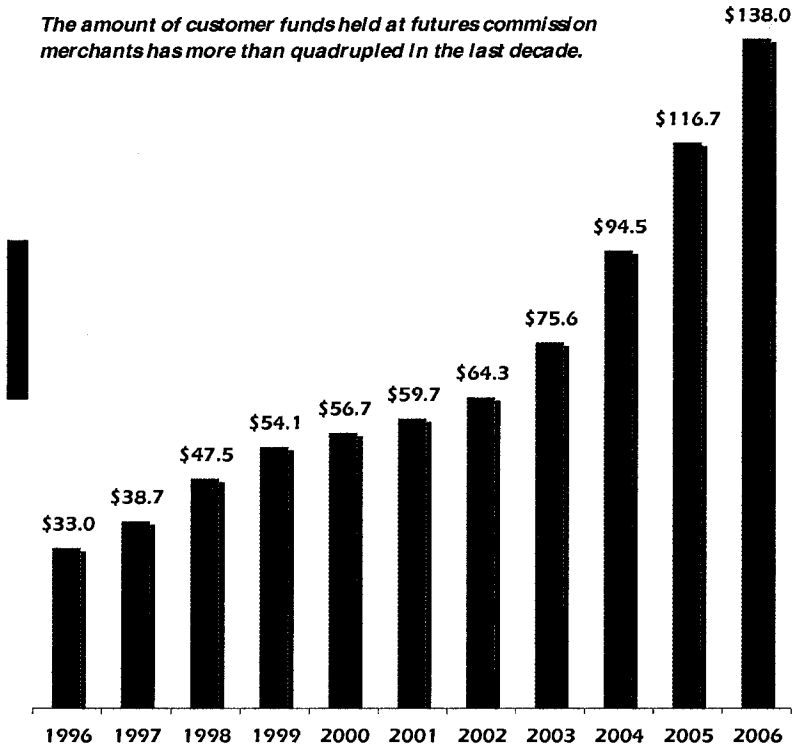


FIGURE 3.—*Customer Funds in FCM Accounts*

Enforcement

The CFTC prides itself on its vigorous enforcement operation. Through strong enforcement, CFTC polices the markets—going after unscrupulous firms and individuals both on and off-exchange. Manipulation, fraud and other violations undermine the integrity of the market and the confidence of market participants.

Figure 4 presents the results of the Commission's recent enforcement activity in the foreign currency and energy areas respectively. In the foreign currency or FOREX markets, 93 cases involving 354 entities or persons were filed with over $292 million in sanctions levied and $182 million in restitution. Since the collapse of Enron, CFTC brought 35 cases involving energy markets and charged 55 entities or persons with manipulation, attempted manipulation, and/or false price reporting. The collective civil monetary sanctions levied exceed $302 million in these matters.

Actions Taken Since Passage of the CEMA in December 2000	Foreign Currency Markets
Number of Cases Filed or Enforcement Actions	93
Number of Entities/Persons Charged	354
Number of Dollars in Penalties Assessed:	
Civil Monetary Penalties	$292,042,098
Restitution	$182,471,571

Actions Taken Since Enron Bankruptcy in December 2001	Energy Markets
Number of Cases Filed or Enforcement Actions	35

Actions Taken Since Enron Bankruptcy in December 2001	Energy Markets
Number of Entities/Persons Charged	55
Number of Dollars in Penalties Assessed: Civil Monetary Penalties	$302,863,500

FIGURE 4.—*Spotlight on Foreign Currency and Energy Markets*

With the demand for enforcement resources exceeding capacity, CFTC must make hard choices every day on how to prioritize our investigative and litigation efforts.

Mission Support

The three major Commission programs are complemented by other offices, including our Office of the Chief Economist, Office of the General Counsel, Office of International Affairs and Office of Proceedings. The Commission's Executive Direction is comprised of the chairman's and Commissioners' offices providing agency direction, and stewardship over CFTC's human capital, financial management, and information technology resources.

The Commission is headquartered in Washington, DC, and maintains regional offices in Chicago, New York, and Kansas City. In recent years, budgetary considerations led to the decision to close the Los Angeles and Minneapolis offices.

When looking at the increased volume of activity across all areas of the CFTC mission, and the scope of the industry change since 2000, the resulting increase in specialized workload is demonstrable. Accordingly, it is critical that the CFTC have sufficient resources to hire and maintain requisite skilled talent, as well as provide a steady stream of technology investment commensurate with the agency's expanding and evolving mission.

FISCAL YEAR 2008 PRESIDENT'S BUDGET REQUEST

We are grateful for the administration's recognition of the need for increased funding for our agency.

The fiscal year 2008 President's budget request, as seen in figure 5, is for an appropriation of $116 million and 475 staff-years, an increase of approximately $18 million and 17 staff-years over the fiscal year 2007 continuing resolution appropriation of $98 million which supports a level of 458 staff-years.

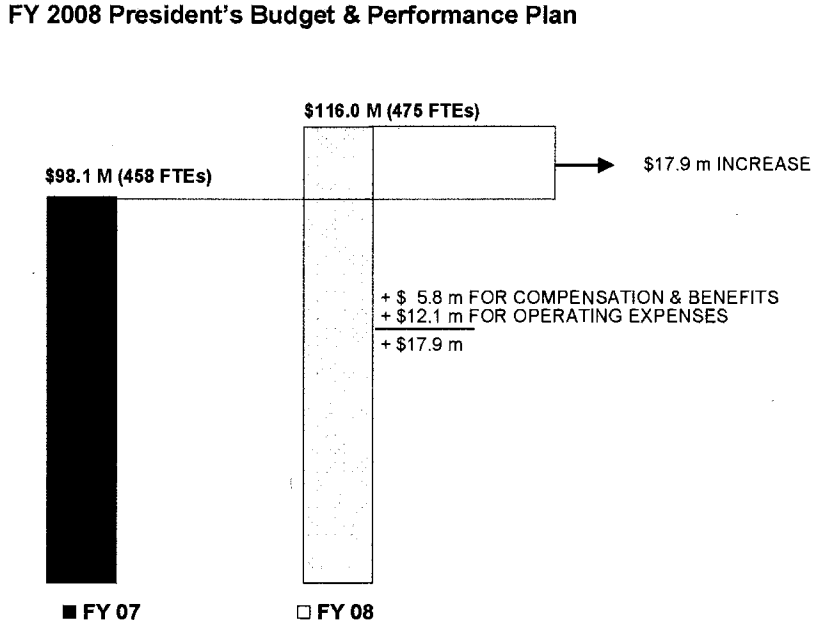


FIGURE 5.—*Fiscal Year 2008 Budget Request Provides for Current Services and 17 Additional FTEs*

Compared to the fiscal year 2007 continuing resolution appropriation, key changes in the fiscal year 2008 budget are:

—$2.8 million to provide for increased compensation and benefit costs for a staff of 458 FTEs;

—$3.0 million to provide for salary and expenses of 17 additional full-time equivalent staff-years;

—$12.1 million to provide for increased operating costs for information technology modernization, lease of office space, and all other services.

This funding increase provides the Commission with the financial wherewithal to hire additional staff and to invest in technology. In staffing, the CFTC must compete for talent not only with the private sector, but also with the SEC and other Federal financial regulators. Four years ago, the Congress improved our ability to compete, granting the CFTC comparable pay authority with other financial agencies (so called "pay parity" through FIRREA). For this authorization to level the compensation "playing field" all of us are deeply grateful. However, the agency has not yet been fully appropriated to the level of comparable FIRREA agencies.

Second only to our human capital, technology is the single most effective tool in assisting those professionals who oversee the markets. Budgetary constraints have required the Commission over several years to put new systems development initiatives and hardware and software purchases on hold, as indicated in figure 6.

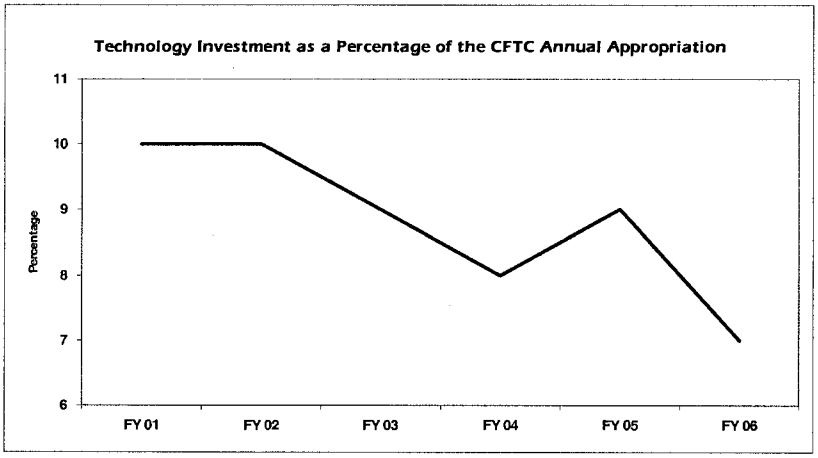


FIGURE 6.—*Technology Investment*

CFTC analysts rely primarily on two proprietary computer systems for visibility into the markets. One gives us the ability to see who is trading in the markets and who is building leverage in the market or becoming a large trader—thus developing a position that may influence market conditions. The second allows us to pull in all transactional data from traditional exchanges to identify trading patterns that might be indicative of inappropriate or manipulative trading practices. These two major systems are unique in their ability to provide transparency into cross-market trading activity across all futures markets under the Commission's jurisdiction. Their importance to ensuring market integrity cannot be understated.

The Commission respectfully requests the proposed funding increase for mission-critical investments in people and technology in order to keep up with the dynamic commodity futures and options industry. While relatively small in dollar terms this funding increment is necessary to ensure that CFTC continues to be able to fulfill its statutory mandate.

All of us at the CFTC take great pride in our work. I can assure you that we are working diligently and efficiently to fulfill the important responsibilities with which the Congress and the American public have entrusted to us.

This concludes my formal testimony. Thank you for the opportunity to appear before you today on behalf of the CFTC. I would be happy to answer any questions you may have.

An electronic version of the Commodity Futures Trading Commission "FY 2006 Performance and Accoutability Report" is available on the Internet at www.cftc.gov/cftc/cftcreports.htm.

Senator DURBIN. Thank you very much. I note the presence of Commissioner Walt Lukken. Thank you for joining us and I'd say to Senator Bond, I started a few minutes earlier with my opening statement because of the vote we face at 9:30 but I'll give you a copy to read on the plane back to St. Louis.

Senator BOND. I can't wait.

Senator DURBIN. I know you can't. Thank you for joining us this morning. Let me ask you a few questions, Chairman Jeffery and then turn to my colleague.

Your current staff level is 450. It's the lowest in the history of the CFTC Commission as I understand it. The graph you presented at the outset depicted the surge in industry volume growth and it's a sharp contrast with stagnated staffing levels. It makes a compelling case as to whether or not you are prepared to really meet this vast increase in the volume of activity and the increased sophistication of the trading mechanisms that are at hand.

I'm informed the CFTC lost 58 experienced employees in fiscal year 2006, 23 more to date in fiscal year 2007. The 81 staff that have departed include 26 attorneys, 7 economists, 8 futures trading specialists, 9 division office directors, 2 commissioners, 15 executive and management support and 14 staff in other job categories. Moreover, since October 2005, you've been operating under a hiring freeze.

I also have jurisdiction in the subcommittee over the Securities and Exchange Commission. It is interesting to note what is going on there. In 1976, there were 2,054 employees at the Securities and Exchange Commission. By 2006, the number was up to 3,549, a 73-percent increase in staffing at the Securities and Exchange Commission, which has a similar responsibility as the CFTC. While their staffing went up 73 percent, in the period of time here, yours has gone down by about 10 percent while the volume of trading and activity, as we mentioned earlier, has increased dramatically.

Let me ask you this. Is the $17.9 million increase in funding that the President seeks adequate for you to meet your responsibility to protect those who were involved in this marketplace?

Mr. JEFFERY. Thank you, Mr. Chairman, for that excellent question. The $17 million—let me put that into perspective. Of that $17 million, $14 to $15 million is simply to maintain current levels of operating activity. That pays for built-in cost-of-living increases, salary increases, et cetera, leasehold increases, and other operating expense increases of a normal course nature. Only $3 million of that number is for an increase in service, if you will. That will allow us to hire an additional 17 full-time equivalent employees. I would say that—were Congress to approve, to appropriate $116 million for the CFTC this year—in our view, it would help maintain current levels, modestly increase our capability in certain areas but it should be viewed as a beginning not an end point of addressing what has been, as you correctly point out in your observations, a steady erosion in our capabilities over the course of the past several years.

Senator DURBIN. In the 1980s banking crisis, Congress passed FIRREA, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which replaced the Federal Home Loan Bank Board with the Office of Thrift Supervision and also provided pay

parity, which you referred to in your testimony, among Federal financial regulatory agencies. You noted in your testimony that you were glad that you were given the authority to pay at equal levels to similar operations in the Federal Government but you also noted that you weren't given the money to raise the pay at your agency so that you could reach parity. Is this, do you believe, part of the reason that you've lost so many staff people in the last 1½ years?

Mr. JEFFERY. Thank you, Mr. Chairman. There are a number of reasons for the staff level reduction, most significantly, budgetary. I should also add that at the CFTC, like many areas of the Federal Government, we're managing what one could describe as a difficult sort of demographic development where there are any number of employees who started at the Commission really at the time of inception, going back 25, 30 years who have now reached that period in their careers, in their lives, where they are eligible to retire in the normal course.

With respect to pay parity, I believe we have funded pay parity to a large extent. Based on the best data we have available today, we're probably about 85 percent fully funded. In other words, on the average and on the whole, our people are at the 80 to 85 percent level relative to their peers at other pay parity agencies that are fully funded. This increment to the budget will allow us to continue to close that gap. I should stress again on pay parity, the importance of having that flexibility for our agency in retaining people who might otherwise be attracted to another U.S. Government financial regulatory agency, let alone the private sector.

STUDENT LOAN REPAYMENT PROGRAM

Senator DURBIN. Chairman, a few years ago I tried to reinvigorate or invigorate, I should say, a student loan repayment program, to recruit high quality individuals to Federal service who might otherwise be discouraged by Federal pay and student debt. I'd like to know if your agency is using student loan repayments to help attract skilled employees?

Mr. JEFFERY. Senator, I don't believe so, Mr. Chairman but I would like to come back to you for the record with a proper and correct answer to that question.

[The information follows:]

The Commission has not had the opportunity to develop the Student Loan Repayment Program as a recruitment tool. Funding constraints have required the Commission to make significant reductions in operating accounts and to place a freeze on the hiring new staff since October 2005. The few limited exceptions to the hiring freeze have been to fill behind key critical losses in hard to fill and one of a kind positions. This limited number of hires has been at the upper levels of management, which is generally not the target beneficiary group of the Student Loan Repayment Program. We understand and appreciate the recruitment benefit of the Student Loan Repayment Program and given the financial flexibility to fill our ranks with more junior talent would look to such a benefit as a key recruitment tool.

CRITICAL INFORMATION TECHNOLOGY SYSTEMS

Senator DURBIN. My last question relates to technology, which was, I think, your last graph. I understand that two of the Commission's three critical information technology systems, market surveillance, and trade practice, are becoming antiquated. I've been advised that $4 million in investments in these systems and other

crucial technology has been deferred, due to your budget challenges. What impact is this situation having on your ability to keep pace with the rapid, explosive technological, and global growth evolution of the markets, which you have the responsibility to supervise? I think we're all aware that this marketplace has not only changed internally, it's changed externally. We're now in global competition and the technology that is available for around the clock trading around the world is a challenge not only to the markets in the United States but to others and to your agency. So have you been able to keep up in terms of technology changes? Do you have the tools to do your job effectively?

Mr. JEFFERY. Mr. Chairman, technology, as you correctly note, is an extremely important tool to all of us who work in the Federal Government, particularly to a financial market regulatory agency. The $116 million budget request has within it a technology spend level of approximately $17 million, which is more than double our spend on technology in the current fiscal year. That allows us to continue to operate our existing systems with some degree of efficacy but it does not allow us to modernize those systems in the way that we believe will be essential for us to continue to be able to fulfill our responsibilities in the years to come as these markets continue to evolve.

They are working currently but we are at risk of them, at some point, becoming outdated if we don't continue to invest in technology and particularly in the two critical systems, trade practice and market oversight, which I described in my testimony.

Senator DURBIN. I'll just conclude and turn to my colleague here by saying that I think that the competitive edge for America in futures trading is the efficiency and integrity of our marketplace. Your agency has the responsibility to make certain that we do everything in our power to protect that competitive edge and to protect those who are participating in the marketplace. When I see the staffing levels that you're struggling with, in comparison even to other agencies of our Government with similar responsibilities, and when I see the problems that you face in developing the technology and capability to keep up with market changes, I'm very concerned. I think that if you are going to be the cop on the beat, you need to have the tools to make sure that you can enforce the laws and catch those who are violating them and I'm worried that this budget will not give you that capability. So we'll take a close look.

Senator Bond.

Senator BOND. Thank you very much, Mr. Chairman. It's a pleasure to be with you on this newly formed subcommittee and I look forward to working with you and Senator Brownback and the other members of the subcommittee. I share your interest and the views that you have expressed and the importance of adequate and effective regulation by the CFTC. I know the chairman has a specific interest in things going on in Chicago as I have an interest in things going on in Kansas City. So we will look forward to working through this subcommittee to provide, try to provide you the assistance that you need to do an effective job in regulation.

And speaking of parochial matters, I noticed that Josh Kinney underwent Tommy John surgery, putting the Cardinals bullpen at risk for this season but I will save my comments for Mr. Preston

because I have a particular area of interest there and I will await his appearance to make my statement about that. Thank you.

[The statement follows:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

Mr. Chairman, Senator Brownback: I am pleased to be with you at the first meeting of the newly formed Subcommittee on Financial Services and General Government. It is an honor to be a member of this Subcommittee. I look forward to working with both of you and other Subcommittee members during the coming months.

Welcome Mr. Jeffrey and Mr. Preston; we are pleased to have you with us.

With all due respect to Mr. Jeffrey, in the interest of time, I will focus my comments on the Small Business Administration.

Mr. Preston, congratulations to you and Ms. Carranza on your successes. SBA under your leadership is a revitalized agency. I am hearing very good things about the agency. So please keep up the good work.

That said, there are a couple of areas of the SBA's Performance Budget that I am concerned about.

With respect to procurement, the Performance Budget states that there will be a review of the Small Business Innovative Research (SBIR) and Small Business Technology Transfer (STTR) programs and "based on these reviews, SBA will recommend legislative, and proposed regulatory, changes." The Performance Budget goes on to state "The SBA will continue to improve oversight and evaluation of SBIR and STTR Programs."

As we all know, the SBIR and STTR programs function as more than simply procurement programs. The SBIR program was created by Congress in the early 1980s to provide new contracting opportunities for small companies and to foster innovation and commercialization of innovative products by small companies.

The NIH SBIR program, for example, helps small medical device, biotechnology and diagnostic firms to access critical early stage capital. These funds help companies get a product off the drawing board and, after a great deal of time and significant additional private funding, to the marketplace.

I continue to be concerned that the SBA is stifling innovation in cutting edge companies in biotechnology and other industries that rely heavily on venture capital funding.

The biotech industry is like no other in the world because it takes many years and intense capital expenditures to bring a successful product to market.

According to a study by the Tufts Center for the Study of Drug Development, it takes roughly 10–15 years and $800 million for a company to bring just one product to market.

For 20 years—until 2004—the Small Business Administration's Small Business Innovation Research program was a catalyst for developing America's most successful companies, helping to fund the critical start-up and development stages of a company.

But then, the SBA decided that small businesses relying heavily on venture capital research funding no longer qualified for the SBIR program.

The arbitrary change in eligibility standards inequitably penalized biotech firms and has delayed—maybe even prevented—lifesaving drugs and life-enhancing medical innovations from reaching patients and consumers.

Last year I offered legislation to correct this situation which restores the original interpretation of eligibility and allows more biotech and medical device companies again to compete for funding under the SBIR program.

My amendment was included in the Small Business Administration's reauthorization bill, which unfortunately fell victim to late session realities at the end of last year.

I am also concerned about the Administration's lack of enthusiasm for the HUBZone program.

Ten years ago, as Chairman of the Small Business Committee, I wrote the legislation authorizing the Historically Underutilized Business Zone, or HUBZone program.

Enacted in 1997, the program provides an incentive for companies to locate and provide jobs in the nation's inner cities and depressed rural areas by giving them a government contracting preference.

Last time I checked, there was still a need for good jobs in the distressed areas of our big cities and small towns.

I look forward to working with you on these and other small business issues.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Bond and I also note for the record, this is the 99th anniversary of the last World Series appearance of the Chicago Cubs.

Senator BOND. That's why I'm glad you're also a Cardinal rooter.

Senator DURBIN. He knows my roots.

Senator BOND. I hate to blow your cover.

Senator DURBIN. He knows my roots in east St. Louis, Illinois. I just—I'll close by thanking you for being here. We will work informally with you beyond this hearing to talk about your staffing and technology needs. I really have a special interest in this because I know how important these markets are to the United States and to my home State of Illinois and I know the people there want to make sure that your agency has the tools and the resources to be effective. Chairman Jeffery, thank you for testifying today.

Mr. JEFFERY. Thank you very much, Mr. Chairman. It's a pleasure.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. As I mentioned at the outset, for those who weren't here, we have a 9:30 vote and I'll have to—it was originally scheduled for 9:15. I think it was changed to 9:30. We'll doublecheck on that and so I may have to break and leave here to tend to my responsibilities on the floor and then return.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. Some members of Congress have introduced legislation placing additional regulations on energy derivatives and the over-the-counter (OTC) markets? Do you think these proposals are necessary?

Answer. We believe that the CFTC has adequate authority to address fraud and manipulation on the regulated futures exchanges subject to CFTC oversight. In regard to transactions on Exempt Commercial Markets (ECM) or bilateral over-the-counter (OTC) transactions, the CFTC supports legislation that would clarify the Commission's fraud jurisdiction in certain principal-to-principal energy transactions under the Commodity Exchange Act (CEA). The CFTC requested the enactment of such legislation during the reauthorization proceedings conducted in the 109th Congress. We support this clarification that the CFTC has the authority to bring antifraud actions in off-exchange principal-to-principal transactions, such as those connected with Enron Online. These provisions were included in the House-passed reauthorization bill last year and the bill reported out of the Senate Agriculture Committee.

In regard to legislation directed at ECMs, it is important to note that in recent months the CFTC has exercised its existing "special call" authority under the CEA to obtain market information from the electronic ECM operated by Intercontinental Exchange (ICE) in Atlanta. The CFTC has utilized this authority to request trader position data on an ongoing basis related to those ICE natural gas contracts that are directly linked to NYMEX contracts. Compliance with these special calls by ICE is mandatory, not voluntary. These special calls have enhanced the CFTC's surveillance of the NYMEX contracts by providing a better window into this marketplace. In regard to the trading of futures contracts based on NYMEX crude and heating oil contracts traded on ICE's London subsidiary, a foreign board of trade fully regulated under U.K. law, the CFTC also has stepped up its coordinated surveillance efforts with the Financial Services Authority in the United Kingdom and is receiving position information on those contracts on an ongoing basis as well.

In regard to bilateral OTC energy transactions, legislation proposing additional regulation could confront significant practical obstacles due to the absence of a centralized marketplace. Under existing enforcement authority, though, the CFTC's Division of Enforcement has committed significant resources to combating problems in

the energy arena, and has achieved significant success in prosecuting manipulation and false price reporting cases. During the last four fiscal years, the CFTC has filed actions charging more than 50 defendants with false reporting, attempted manipulation, or manipulation in the energy sector and has obtained over $300 million in penalties. These cases have been based on well-established CFTC cash market enforcement authority that has been clearly recognized by the courts.

Since the passage of the CFMA in 2000, the futures markets continue to rapidly evolve and grow, domestically and globally—and the CFTC is always monitoring these developments.

Question. It is my understanding that some companies use these over-the-counter (OTC) trading markets to hedge their energy risk and that some of the proposals may provide a disincentive for companies to use these markets. Would a decrease in participants in the OTC markets lead to less transparency?

Answer. There are a number of different kinds of over-the-counter markets, all of which have different levels of transparency. They include cash spot and forward physical markets, bilateral OTC swaps and options markets, and ECMs. It is possible that regulations aimed at increasing transparency in some OTC markets generally could discourage some traders from participating in these markets, resulting in their trading positions being moved to venues not visible to U.S. regulators. However, transparency to the regulator will not necessarily be less than is currently the case. For example, as discussed in the answer to question number one above, transactions moved to ICE in London actually became more transparent to foreign regulators and the CFTC. Finally, it is important to note that exchange markets under CFTC jurisdiction are among the most transparent in the world for both market participants and the regulator.

Question. I am concerned with the recent regulatory direction that the Commission has taken, in apparent conflict with the spirit and intent of the Commodity Futures Modernization Act of 2000 ("CFMA"). As you know, the CFMA eliminated prescriptive regulation in favor of Core Principles that provide exchanges flexibility in determining the best method for achieving compliance with each such guiding Principle. An example of my concern with your regulatory direction is the Commission's final rules regarding acceptable practices for safe harbor compliance with Core Principle 15 pertaining to conflicts of interest in self-regulatory organizations. While there are a few provisions within this final rule that I have concerns with, one in particular is the definition of a "public director" which by its literal reading would appear to exclude almost everyone in corporate America and academia. The test of $100,000 of payments from the exchange or any member or affiliate thereof collectively will result in not only a requirement difficult if not impossible to test for, but will eliminate nearly everyone an exchange could draw from for public director service. How do you expect exchanges to cope with such a wide reaching "public director" definition that eliminates almost all qualified possible public director candidates?

Answer. The CFTC is strongly committed to both the spirit and intent of the CFMA. The CFTC believes that its new Acceptable Practices for Core Principle 15—safe-harbors which exchanges may choose to implement—are an important indicator of that commitment. The Acceptable Practices promote the flexibility inherent to all Core Principles while simultaneously offering the specificity necessary for effective, "pre-approved" regulatory safe-harbors.

With respect to the definition of "public director," the CFTC has determined that it is important to offer all exchanges a clear articulation of those director relationships that may interfere with a director's ability to deliberate objectively and impartially. The definition of "public director" adopted by the CFTC reflects that determination, and is consistent with Core Principle 15's instruction that exchanges must minimize conflicts of interest in their decision-making processes. The CFTC is confident that qualified, competent public directors are available and can be readily identified by all exchanges.

At the same time, as sometimes is the case with legislative text or rule making, the Commission recently proposed certain technical amendments to the definition of "public director" in the Acceptable Practices to correct a drafting error and clarify ambiguities. Among other things, the proposed amendments would clarify, with respect to the $100,000 payments from the exchange test, that "payments" means compensation for professional services. The amendments also provide that, consistent with the Acceptable Practices as originally proposed, entity affiliates of members are not included as payment providers for purposes of the $100,000 payments test. The Commission believes that these amendments should facilitate the inclusion of public directors on exchange boards while maintaining the strong level of public director independence intended by the Acceptable Practices.

The proposed amendments to the definition of public director will be published in the Federal Register and will be open for a 30-day public comment period.

QUESTION SUBMITTED BY SENATOR WAYNE ALLARD

Question. CFTC is currently the only federal financial regulator that is not supported by fees paid by the entities it regulates. Accordingly, the budget proposes a new transaction fee to fund the commission. Can you please describe how this fee would work? How would the fee be paid and at what level would it be set? What would be the impact in the marketplace of adding a new transaction fee?

Answer. In the President's Budget for fiscal year 2008, the Administration included a user fee based on its view that it is appropriate for futures markets to at least partially offset or contribute toward the cost of providing those programs which provide clear benefits to market participants. Unlike last year's proposal, this year's budget recommendation is not dependent on the Appropriators enacting the fee proposal.

If enacted, the proceeds from the fees would be returned to the general fund of the Treasury, to be used to offset the deficit impact of continuing to fund the CFTC's operations through direct appropriations. They would not impact the discretionary spending allocations for the relevant Appropriations subcommittees. The fees would be set at a level equal to the costs to the taxpayer of funding Market Oversight and Clearing & Intermediary Oversight functions, about $86 million during 2008. The Office of Management and Budget in the Administration has not provided us with final details as to how exactly the fee would work or at what level it would be set.

The CFTC has not studied the impact of a transaction fee, nor is it aware of any executive branch agencies that have done so. The Congressional Research Service prepared a report entitled "The Proposed Transaction Fee on Futures Contracts" in April 2006 (RS2241).

STATEMENT OF HON. STEVEN PRESTON, ADMINISTRATOR

Senator DURBIN. But at this time, I'd like to ask the Administrator of the Small Business Administration, Steve Preston, to please come to the table.

I started a few minutes early, Mr. Preston and said a few words about your agency and the budget request so if you'd like, I'd invite you now to give us your opening statement.

Mr. PRESTON. Great, thank you. I'd hoped to start on a high note but after your comment about the Cubs, I'm a little depressed. So I'll try to regroup here.

Thank you, Chairman Durbin and Senator Bond, for inviting me here to talk about our 2008 budget and I'd also like to thank you for the support you all gave us in getting through the 2007 process. We're very excited about the funds that we have for this year and we think we can do a lot with them.

As of tomorrow, I will have been on the job for 8 months. I also want to thank you for approving our Deputy, who was confirmed in December. She is a terrific addition to our team, with 30 years of business experience.

Our 2008 budget request reflects continued commitment to America's small business and the vital role they play in our economy and in our society. Enactment of this request will enable us to continue serving the small business community while also being a good steward of taxpayer dollars.

The SBA's 2008 budget requests $464 million in new budget authority. This is a 5-percent increase over the enacted level in 2006—that's including disaster and congressional initiatives. The budget also requests the use of $329 million in carryover balances to fund disaster assistance, funds that SBA has on hand from the $1.7 billion in supplemental funding from fiscal year 2006. Finally, it includes $21 million in reimbursable expenses for E-Gov, Business Gateway and SDB certifications as well as lender oversight. All told, that is $814 million in overall budget authority.

The budget will allow the SBA to carry out its core functions and begin a number of reforms and improvements. These resources will support a total of up to $28 billion in small business financing through the 7(a), 504, and SBIC Venture programs. For the 7(a) program, we're asking for $17.5 billion in lending authority. For the 504, $7.5 billion and then for the SBIC Venture Capital, the Debenture program, $3 billion.

Because of the strength of our portfolios, I'm pleased to request fee decreases for the 7(a), 504 and SBIC Venture programs. In this budget, the 7(a) annual fee will go down 5.6 basis points, from 55 to 49.4 basis points. The 50 basis point up-front fee for the 504 program is totally eliminated and the SBIC Venture annual fee decreases 18.9 basis points. These fee reductions are significant. They

reflect the success of the zero subsidy program in all of our loans. As you can see from the fee history table that we provided, the 7(a) upfront loan fees for 2005 and 2006 are consistent with those throughout the past decade except for the 2003/2004 timeframe. In a reaction to the economic impact of 9/11, Congress cut the fees for that period of time.

Unfortunately, the result of cutting the fees was to increase the rate at which the SBA subsidy was used, which ultimately shut down the program and required additional appropriation. Zero subsidy has avoided those types of shut downs while the 7(a) program has continued to flourish.

For disaster loans, our proposed 2008 budget supports a loan volume of $1.064 billion. That funding comes from carry over from our current disaster funds.

For counseling and training to small business through SBA's network of resource partners, in small business development centers, SCORE, and women's business centers, we're asking for a total of $104 million.

In terms of our workforce, the budget will support an increase to 2,123 FTEs through the salary and expenses budget. That would include 86 new positions to be added in 2007 and 2008. These additional resources are, in part, replacements for attrition at the agency in recent years but they will also support other things like stronger loan processing and lender oversight, greater support of small business in our Government contracting operations, better employee training and career support, as well as a greater focus on automation and outreach.

SBA has a growing responsibility as a financial manager. Our portfolio has increased 56 percent over the past 5 years and we now have almost $78 billion in financing to oversee. To meet that responsibility, our budget has requested funding for human capital and information technology.

The budget includes $4.1 million for investment in the loan operations system upgrade, to provide implementation of a system to replace our current loan information system for both regular loan programs and the disaster servicing program. This major agency-wide undertaking began in 2006 and is on track to be completed by 2012.

It also includes expanded SBIC oversight with $1.5 million to support evaluation contracts, liquidation planning, and an examination contract. This investment will help maximize recoveries and minimize losses.

We also continue to improve our lender oversight process, which enables us to be more effective in managing credit risk.

Federal contracting dollars are projected to increase by 64 percent over 2001 and as I mentioned before, small businesses share is expected to grow. We expect that to be $84 billion in 2008. Our responsibility is to ensure that small businesses have fair access to procurement opportunities. What I like to tell people is it's not just a matter of fairness, it's also a matter of competitiveness. Small businesses perform well as suppliers of goods and services. Their size makes them flexible, innovative, and often cheaper than large companies. It does, however, take a bit more effort to find the right small business to fit the bill.

So in our 2008 budget, we are requesting about $500,000 to help improve our service to the 8(a) HUBZones, STB, as well as women's and veteran's communities. We're proposing to add nine new procurement center representatives in 2007 and 2008, which is an expansion of 16 percent. In addition, we're working to reform the contract goaling and reporting processes and we're redoubling our efforts to ensure that Federal agencies provide accurate data on small business procurements.

For 2008, we are also requesting an increase of $500,000 to expand our veteran's outreach. With the Nation's current engagement in Iraq and our presence in Afghanistan, the number of veterans returning from active duty is going to continue to increase. Our Office of Veteran's Affairs plans to increase its efforts to educate and provide programs and services to veterans and active duty personnel in three major areas: access to capital, management and technical assistance, and procurement assistance.

Even though we've already made many reforms in our disaster assistance program, we're committed to lasting reforms geared toward future disasters, whatever their scale might be. We're developing organizational tools and a detailed documented escalation plan, which we think will improve our response. These plans will include models to rapidly forecast loan volume resource requirements and coordination requirements to position the agency to respond effectively to large-scale disasters.

We are also working to implement an Internet-based electronic application tool to enable borrowers to submit information electronically, quickly and accurately, to accelerate our ability to access their loan eligibility.

The agency is also evaluating options to access the private sector skills and resources when dealing with catastrophic disaster events.

Finally, one of my highest priorities as the Administrator is to improve the work that we are doing to reach underserved areas of our country. In areas where we see high unemployment and lower wage rates, like many rural and inner-city areas of our country providing effective support to new and growing small businesses can provide much-needed jobs, economic activity and rejuvenation in places in our country that need it the most. In order to reach these markets, SBA has included the following proposals in our budget: broadening lender involvement in the Community Express Pilot Program so we can expand this program, which reaches into many of our underserved markets and provides borrowers with a double benefit of capital and counseling; expanding the Urban Entrepreneur Partnership to additional cities so aspiring urban and small business owners have better access to capital and services that will make them successful; establishing seven more alternative work sites, which allows the agency to make itself more accessible to rural customers; and expanding the potential reach of the microloan program by moving the program to zero subsidy.

As I said before, I think this is a sound budget. It gives the SBA the funds necessary to oversee and operate our core financial programs more effectively, to re-engineer and improve our Government contracting programs and to continue our work with counseling and training partners. It will also enable us to provide more

effective outreach, be easier for our customers and partners to work with through better automation, and fill key staff positions in areas that are clearly lacking in necessary manpower.

PREPARED STATEMENT

So thank you for your consideration and I look forward to answering any questions you might have.

[The statement follows:]

PREPARED STATEMENT OF STEVEN PRESTON

Chairman Durbin, Ranking Member Brownback, distinguished members of the Committee, thank you for inviting me here today to discuss the President's fiscal year 2008 budget request for the U.S. Small Business Administration (SBA).

First, I would like to thank you all for assisting us in obtaining the additional funding for disaster and other agency administrative needs for fiscal year 2007. The added general agency administrative funding will allow us to appropriately address our staffing and other administrative priorities for the remainder of fiscal year 2007. The disaster administrative funding should ensure that the Agency will be able to effectively operate the disaster loan program until late July, barring any unforeseen major disasters. We look forward to working with you to obtain the remaining $26 million needed for fiscal year 2007 disaster administration in the upcoming supplemental appropriations bill. We appreciate your commitment and understanding of the vital role small business plays in the American economy.

President Bush has been an unwavering supporter of America's small businesses, and his leadership has ensured that they have played a vital role in our economic growth. There have been more than 7.4 million new jobs created since August 2003. We know that the majority of those jobs were created by employers in the small business community. In fact, analysis by the Bureau of Labor Statistics shows that small businesses generated 65 percent of the net employment growth between September 1992 and March 2005. This growth has helped reduce the unemployment rate to 4.5 percent, the lowest rate of the past four decades. By reducing the tax rates small business owners pay and increasing expensing tax provisions on investments, small businesses have more capital available to hire new workers and expand their businesses.

The President is also committed to helping small business owners provide health insurance to their employees by supporting association health plans, allowing small businesses to get the same discounts on health insurance as big businesses. Further, the Administration is working tirelessly to ensure that small businesses are able to grow, and expand opportunities for their workers, by providing regulatory relief and opening markets abroad to ensure that America's trading partners play by the rules and make it possible for our small businesses to export their products.

SBA's fiscal year 2008 budget request reflects the President's commitment to America's small businesses and the vital role they play in our economy. Enactment of this request will enable SBA to continue serving the small business community while ensuring stewardship of taxpayer dollars. The fiscal year 2008 budget request provides resources will total an estimated $814 million. This amount includes $464 million in new Budget Authority, $329 million in spending from carry-over balances for the Disaster Loan program, and $21 million in reimbursable services.

This budget request reflects both the vision of the Agency's new leadership team and the progress the Agency has made over the past five years in delivering its programs more efficiently. Since 2001, SBA has achieved major growth in nearly all of its programs while simultaneously streamlining processes and developing more cost-effective budget strategies. Fees for all of the Agency's non-disaster loan products have been lowered and for the first time ever the borrower fee for 504 loans has been completely eliminated while continuing to operate the program with no loan subsidy from the taxpayer.

The new management team will continue to pursue this expansion in services to the small business community while aggressively pursuing a Reform Agenda to ensure the Agency's programs are customer-focused, outcome-driven and fiscally responsible and sound. In addition, further enabling our employees to fulfill SBA's mission is an essential element in achieving our objectives in this budget.

REFORM AGENDA

I am pleased to be heading the new SBA management team that includes Deputy Administrator Jovita Carranza, who was just confirmed in December. SBA's agenda

is grounded in the belief that the Agency can improve the effectiveness and impact of its programs and activities markedly, by employing important management principles. These principles will seek to ensure that the Agency is driven by clear outcomes, is focused on serving its customers effectively, enables its employees, and operates a compliant and accountable organization.

The Agency also has a renewed focus on ensuring that its products and services are accessible to entrepreneurs in the nation's most underserved markets—those with higher rates of unemployment and poverty and lower rates of economic progress. This budget request highlights SBA's progress to date and describes the Agency's plans for achieving the vision of the new management team in fiscal year 2008.

In 2001, SBA began a drive to deliver more value to the Nation's small businesses while lowering costs to the taxpayer. By restructuring key Agency operations and reengineering its largest loan programs, SBA has achieved record program growth of 56 percent in the loan portfolio, while reducing its total cost by 31 percent since 2001 through increased operational efficiencies and core program improvements. The most important factor in this cost savings has been the 7(a) loan program's operation at zero subsidy. With Congress' support we were able to change the 7(a) program in fiscal year 2005, saving the taxpayers approximately $100 million in subsidy and allowing the program to operate without interruption. In years past the program had run out of available subsidy funds which shut the program down until a new appropriation could be approved. With the zero subsidy operation in place the program has been able to expand without the threat of a shut down. Zero subsidy is good stewardship of taxpayers' money while creating a more stable loan program for small businesses.

Through its ongoing restructuring and business process reengineering, SBA has improved and will continue to improve the effectiveness of the taxpayers' dollars supporting small business development. Because of these improvements, SBA will be able to serve record numbers of small businesses in fiscal year 2008 with this budget request.

The principles of SBA's Reform Agenda have already resulted in a dramatic improvement in the Agency's Disaster Loan program. The 2005 Gulf Coast hurricanes resulted in SBA's largest disaster response in its 53-year history. More than 420,000 loan applications from Hurricanes Katrina, Rita, and Wilma (three times the level for the second largest disaster, the Northridge earthquake of 1994) left the Agency struggling to meet its loan processing standards and frustrated many.

Almost immediately after being sworn in as SBA Administrator in July, 2006, I spearheaded a fundamental reengineering of the disaster loan processing operation that has dramatically shortened response times, improved quality, and increased borrower support. Backlogs were virtually eliminated and feedback on the new approach has been overwhelmingly positive. We, however, are not finished with the long-term redesign of the disaster process, and are working aggressively to do so in the coming months.

SBA is bringing the same principles used in disaster assistance reform to administering its business guaranty programs as well. Reengineering of the loan servicing process is underway and will result in better customer service and less operational redundancy. Building upon its success in consolidating 7(a) loan liquidation functions from almost 70 district offices to a single location, SBA is also finalizing plans to consolidate 7(a) loan processing, 504 loan liquidation, and Disaster loan liquidation. These changes ensure that loans are managed more consistently and efficiently. In the case of 7(a) loan liquidation, considerable budgetary savings were also realized.

Modernizing agency operations is challenging, but it is essential. The Nation's taxpayers expect SBA to operate using the techniques and practices of sound fiscal and operational management. Through its proactive efforts to improve productivity and performance, while reducing cost, the SBA has demonstrated its commitment to deliver ever better products while improving efficiencies.

With a guaranteed and direct loan portfolio of over $78 billion, SBA has a critical role as a steward of taxpayer dollars. While the portfolio has grown at a record pace in recent years, during that time, SBA has been implementing a rigorous, state-of-the-art risk management program. By using industry data and technology, the Agency is replacing the old, primarily manual processes for reviewing lender performance with automated, quantitative risk-based methods to identify problems earlier and more effectively. This approach is improving oversight while there continues to be a period of strong growth in the loan portfolio.

HIGHLIGHTS OF THE BUDGET REQUEST

SBA's budget request represents an increase of 5 percent for fiscal year 2008 above our enacted level in fiscal year 2006 (excluding the Disaster program and earmarks). The overall request is for $814 million in proposed Budget Authority. This includes $464 million in new Budget Authority and $329 million funded out of carryover balances from the $1.7 billion in supplemental funding received in fiscal year 2006 for the Disaster Program. Some critics have misinterpreted this request by dismissing the $329 million to be carried over from overages in the disaster loan subsidy account. The creation of State grant and loan programs, the influx of insurance payments previously thought to be uncollectible and other factors have shifted the needs of Hurricane victims. The result is that they need less loan authority than estimated in 2006 but the constant changes and delays in rebuilding require more administrative and staffing needs until the borrowers can actually rebuild. Currently, there is sufficient carryover balance in the disaster loan subsidy account to cover the additional Katrina related administrative costs as well as those for a normal disaster year in 2008. Therefore we have asked for transfer authority from the overage in disaster subsidy to cover administrative costs.

These resources will support a total of $28 billion in lending authority for small business financing, which represents a potential 40 percent increase over business lending for fiscal year 2006, through the 7(a), 504, and SBIC debentures programs. For its flagship 7(a) program, SBA requests authority for $17.5 billion—a 27 percent increase over the fiscal year 2006 lending level. SBA also requests authority for $7.5 billion for the 504 program, a 32 percent increase over loans made in fiscal year 2006—a record year for 504 lending. Finally, SBA requests an SBIC Debenture program of $3 billion.

In addition, this budget will support the following:

—A disaster loan volume of $1.064 billion (the Agency's ten-year average based upon fiscal year 1996–2005 average activity, excluding the WTC disaster, adjusted for inflation).

—Counseling and training to small business people through SBA's network of resources partners in Small Business Development Centers (SBDC), Service Corps of Retired Executives (SCORE), and Women's Business Centers.

—Assist federal agencies targeting a total of $84 billion in prime federal contracting dollars to be awarded to small businesses in fiscal year 2008.

—Investing in the Agency's human capital through job skills training, mentoring programs, succession planning, proactive recruitment of highly qualified staff, and implementation of an automated personnel records system.

—Maintaining employee security through continued implementation of Presidential Homeland Security Directive #12 and support of major security improvements in the headquarters building.

—Continuing the process of implementing a loan operations system to replace the current outdated system in order to better track payments as well as increase the Agency's loan portfolio oversight.

—Enhancing SBIC oversight and recoveries.

—Providing a cost effective microloan program.

—Continuing efforts to make it easier and faster for small businesses to comply with government regulations.

—Improving SBA products, services and delivery.

SBA's budget request will support 2,123 FTE through the Salaries and Expenses budget. This staffing level is an increase over both the fiscal year 2006 actual level and the fiscal year 2007 requested level. SBA has been able to reduce its budgetary requirements and staffing levels over recent years, but these increases are necessary to support critical oversight and portfolio management functions. Nevertheless, SBA has managed significant administrative savings while increasing financing, counseling, and government contracting opportunities for small businesses. SBA has been streamlining its operations and eliminating costly and inefficient programs, including the following examples:

—The Agency centralized its financial processing operations. As a result, 7(a) loan liquidations cost approximately $18 million less in fiscal year 2006 than fiscal year 2003.

—The Agency created an alternative to the LowDoc program for 7(a). A part of our SBAExpress program, Community Express is 20 times less expensive than LowDoc ($4,771 per loan approved for LowDoc vs. $227 for SBAExpress). Lenders still have access to the higher 85 percent guarantee for smaller loans formerly available through LowDoc but benefit from the improved process under other 7(a) products, such as Community Express.

—SBA continues to seek opportunities to reduce rented space. The initiatives we have implemented from fiscal year 2004–2006 resulted in $3.8 million in annual rent savings.

DISASTER

In the summer of 2006, we initiated the Accelerated Disaster Response Initiative to identify and implement process improvements to help the Agency respond more rapidly in assisting small businesses and homeowners seeking financial assistance after a disaster. As a result, the Agency fundamentally reengineered its disaster loan processing operation to shorten response times, improve quality, and provide greater borrower support. Based on customer feedback, the Agency rolled out an "integrated team" model. Each team comprises 15–18 employees with legal, financial, and other required competencies to ensure timely, coordinated loan processing. Customers are assigned to a case manager on the integrated team so they have a single point of contact that is responsible for guiding them through the loan process and ensuring that SBA is responsive to their timing and other requirements.

Under the new model, case managers now proactively contact applicants to determine what impediments exist to closing loans and making disbursements. In addition, in order to complement SBA's reengineered process, the Agency has implemented numerous metrics to track application status and performance of employees. All applications are categorized by processing status and type of outstanding issue. This provides management with the necessary information to identify problem areas and implement corrective actions. Further, productivity is monitored to identify areas that require management intervention. These strategies are the foundation for improved responsiveness to borrower needs. For example, the time needed for loan modifications that averaged more than 2 months in July, 2006, now averages 8 days, and continues to decline. In addition, the backlog of loans for modification has declined over 90 percent since July.

Additional organizational planning measures to improve SBA's disaster response include development of models to rapidly forecast loan volume and resource requirements (financial, human capital, and logistics) to better position the Agency to respond to large scale disasters when they strike. Moreover, SBA is nearing completion of a protocol to leverage its field network to improve local coordination and communication with citizens and other local authorities.

By 2008, SBA expects to implement an internet-based electronic loan application process to ensure that borrowers' required information is provided to assess loan eligibility. This complements SBA's investment in the disaster computer system that has been tested to support a four-fold increase in concurrent user capacity to 8,000 users. The agency is also evaluating options to access the private sector's skills and resources when dealing with catastrophic disaster events.

COMPLIANT AND ACCOUNTABLE ORGANIZATION

Listed below are the actions SBA has initiated and planned along with specific funding requests regarding its loan and investment portfolio:

—Investment in technology for the loan operations system upgrade of $4.1 million in S&E (to be complemented by about $4.2 million in disaster funding) for project management support, and to acquire and begin implementation of a system to replace our current loan information system for both regular loan programs and disaster loan servicing. Currently, the Agency's business loan operation runs on a Cobol-based system which limits technological advancement opportunities and security. The older system is also significantly more costly to maintain. SBA is making good progress on this major Agency-wide undertaking, which began in fiscal year 2006, and is on track to be completed by 2012. Requested funds for fiscal year 2008 will enable SBA to finalize the business vision, develop the project management plan, and finalize technical and functional requirements.

—Expanded SBIC Oversight with $1.5 million in S&E to continue the valuation contract, develop a liquidation plan, and implement an examination contract. This investment will help maximize recoveries on the $1.5 billion in the Office of Liquidation, and minimize losses on the currently $10.3 billion in outstanding leverage and commitments in the Office of Operations.

—Loan and Lender Monitoring System and Lender Reviews—SBA's Office of Lender Oversight (OLO) has a state of the art loan and lender monitoring system that incorporates credit history metrics for portfolio management. The credit information, combined with SBA lenders' current and historical performance, allows the Agency to assign risk ratings to lenders. Such ratings provide both an assessment and a monitoring tool for the most active SBA lenders, and are

the primary basis by which lower volume lenders are evaluated. High risk lenders are under direct oversight of OLO rather than the program office. In addition, OLO is responsible for conducting on site lender reviews and examinations. Through fiscal year 2006, the Agency has not had resources to conduct as many reviews as we believe are necessary. However, because the Agency recently received authority for reimbursement for the cost of these reviews, SBA plans to conduct additional reviews in fiscal year 2008.

—Portfolio Analysis Committee—Senior Capital Access and CFO Managers meet monthly to review and assess portfolio trends and identify opportunities for program improvements. This committee is an important component of SBA's risk management program. The committee assesses the risk of the 7(a) and 504 loan programs and performance trends. Based on analysis and management direction resulting from these meetings, program changes, operational initiatives, and other actions are generated. For example, in addition to providing support for the elimination of the LowDoc program, the committee's review efforts resulted in the initiative to reduce the backlog in liquidations and charge-offs in our 7(a) portfolio.

—Lender Oversight Committee—Senior managers meet bi-monthly to review lender trends and review corrective actions for poor performing lenders. As mentioned, Lender Oversight has introduced risk ratings to monitor and evaluate SBA lenders. The committee is also provided results and performance metrics on lender oversight activities such as examination reports, and corrective action plans for lenders under OLO's direct oversight. SBA has placed several lenders under corrective action plans and continues close monitoring to improve performance.

—Lender Portal—Lenders now have access to their risk ratings and performance metrics through our lender portal, making it transparent to lenders what they are rated on and how they compare with their peers. It allows lenders to address data quality issues to improve their risk ratings, which the Agency believes will ultimately result in significant improvements in data quality. The information is also available to SBA's district offices to help identify training opportunities for lenders.

—SBIC Liquidations—SBA currently oversees approximately $1.5 billion in SBIC leverage in its Office of Liquidation and $10.3 billion in leverage and commitments in its Office of Operations. Collecting on the large amount of leverage outstanding in the Office of Liquidation continues to be of great concern. The staff has developed a comprehensive strategy for liquidating this portfolio of investments. As part of this strategy, several pilot initiatives for liquidating SBIC assets are being pursued to ascertain the most cost efficient means of disposing of this significant portfolio. With $2.4 billion in estimated losses in the Participating Securities (PS) program, oversight on the $10.3 billion in outstanding leverage and commitments for those SBICs (of which almost $7.2 billion pertains to the PS program) remains of high importance.

In addition, SBA is taking the lead, along with the Office of Management and Budget's Office of Federal Procurement Policy, to work with the contracting agencies to ensure accuracy and transparency of the data in the Federal Procurement Data System-Next Generation (FPDS–NG). The agencies are in the process of validating their fiscal year 2005 data to identify the reasons for coding discrepancies and to correct any errors that occurred.

In fiscal year 2007 we expect that all agencies' subcontracting information will be available in the Electronic Subcontracting Reporting System.

CUSTOMER-ORIENTED

The following are highlights of SBA's plans to focus its products and services on underserved markets:

—*Expansion of the Community Express pilot*.—This pilot was designed to reach underserved markets and combines both capital and technical assistance to increase the viability of the businesses it serves. The Agency is working to broaden lender participation in the product and will seek involvement from its counseling and training partners: SBDCs, SCORE, and Women's Business Centers.

—*Expansion of the Urban Entrepreneur Partnership*.—The Urban Entrepreneurial Partnership (UEP) initiative is a community-based referral program located in an urban setting. The Agency has been working to expand the initiative to additional cities that will create a local network of small business resource providers serving urban and inner-city communities (UEPNetwork), as initially outlined by the President in a presentation to the National Urban League in 2004.

—*Expansion of Alternative Work Sites*.—One way the Agency has made itself more accessible to small business is to locate certain district office staff away from single urban centers to locations closer to our customers. Currently, there are 22 such alternative work sites in operation. Another 2 are planned by the end of fiscal year 2007. SBA is seeking $100,000 to set up 7 additional sites in fiscal year 2008.

—*Business Process Reengineering for the Office of Government Contracting and Business Development (GCBD)*.—SBA's request includes $500,000 to examine how to best serve the 8(a), HUBZone, and Small Disadvantaged Business communities as well as women and veterans. We recognize the Agency can improve the management of these programs, particularly the 8(a) program, and will use these resources to determine how to best serve them—whether through staff realignment and training, or technology improvements.

—*New Markets Tax Credit Pilot*.—In October, the Agency launched the New Markets Tax Credit Pilot Loan Program to provide financial assistance to small businesses in economically distressed urban and rural areas, or "New Markets." The pilot program allows certain Community Development Entities (CDE) to purchase up to 90 percent of the gross loan amount of SBAExpress or Community Express 7(a) loans up to $150,000 made to NMTC "qualified" businesses in low-income communities. Administered by the Treasury Department's Community Development Financial Institutions Fund, the New Markets Tax Credit program permits investors to receive credits on their federal taxes of up to 39 percent of investments made in investment institutions called Community Development Entities.

The SBA pilot program, which is only available to 7(a) lenders making new loans through advance-purchase commitments with CDEs, waives a regulation that limits an SBA lender's ability to sell any portion of an SBA guaranteed loan to anyone other than another SBA lender. The waiver allows CDEs with New Markets Tax Credit allocations to purchase up to 90 percent of SBA Express or CommunityExpress 7(a) loans up to $150,000 made to NMTC "qualified" businesses in low-income communities. The New Markets Tax Credit Program is expected to spur approximately $16 billion in investments into CDE investment institutions.

These new loans are guaranteed by the SBA. By leveraging the SBA's resources with the Treasury's NMTC program, the pilot will provide additional access to loans and technical assistance to both start-up and existing small businesses in New Markets. Under the program, Community Express lenders will assist CDEs to provide small business borrowers with a package of services including mentoring, coaching and counseling.

—*Zero Subsidy Microloan Program*.—Small business loans under $35,000 provide a critical level of capital to certain sectors in our economy, many of which are in underserved communities. Our regular 7(a) program reaches many members of this community. In fiscal year 2006, 42,730 loans, representing 44 percent of all 7(a) loans, were made at the microloan funding level ($35,000 or less). However, additional businesses in target markets can be reached through non-bank micro lenders.

The Microloan program as currently structured is costly to the taxpayer. In fiscal year 2006 it cost approximately 85 cents to the government for each dollar loaned to a Microloan intermediary. Therefore, the Agency is proposing a zero subsidy microloan program. By raising the very preferential rate at which intermediaries borrow from 3.77 percent (below the government's cost of funds) in fiscal year 2008 to 5.99 percent (SBA's all-in cost), the Agency can eliminate the subsidy cost of this program and greatly expand funding for microloan intermediaries. Intermediaries will continue to receive a better than market rate of interest on loans and SBA will be able to offer loans to any eligible intermediary.

Furthermore, SBA is proposing that rather than asking for Microloan Technical Assistance funding, SBA should leverage the skills of technical assistance resource partners, including the Small Business Development Centers and Women's Business Centers located throughout the country, to train and counsel micro borrowers. This has the potential of tripling the number of outlets providing training to micro-entrepreneurs for micro enterprise training and will save almost $13 million in fiscal year 2008.

—*Expanding the Veterans' Outreach Program*.—The SBA requests an additional $500,000 for the Office of Veterans' Business Development (OVBD) in fiscal year 2008. With the Nation's current engagement in Iraq and its presence in Afghanistan, the number of veterans returning from active duty will continue to increase. SBA's Office of Veterans Business Development (OVBD) plans to in-

crease its efforts to educate and provide programs and services to veterans and active duty personnel in three major areas: access to capital, management and technical assistance, and procurement assistance programs through SBA, other government agencies, and the private sector. The Agency will accomplish this through existing loan programs, the disabled-veteran-owned business government contracting program, a redesigned website populated with a broad range of programs and services available to veterans, the development of training and mentoring programs for veterans by veterans, and funding District Offices to grow veteran-owned business capacity.

Other customer-focused plans include:

—Helping businesses with compliance through the 24/7 anywhere accessible Business Gateway. SBA requests $4.8 million in reimbursable budget authority for the E-Gov initiative for which SBA is the managing partner and $425,000 in S&E for the project management office (SBA's contribution as managing partner). Business Gateway will provide the Nation's businesses with a single, internet-based access point to government services. It will simplify and improve businesses' ability to locate and submit government forms and reduce the time and effort needed to comply with government regulations. Each year, Business Gateway will increase the time saved by business accessing information and forms by 50,000 hours over fiscal year 2006.

—Increase access to Federal procurement opportunities by adding 9 new Procurement Center Representatives in 2007 and 2008. With total Federal contract dollars projected to increase by 56 percent over fiscal year 2001, the small business share is expected to increase to a total of $85 billion. SBA's responsibility is to ensure small business retains access to these opportunities.

SBA will also continue the development of the Electronic Procurement Center Representative System. During fiscal year 2006, SBA began working on an Electronic Procurement Center Representative (EPCR) System to allow PCRs more timely information about contracting opportunities for small business. It also worked with the Department of Defense to integrate EPCR functional requirements with the DOD's capture of additional pre-solicitation information, and explored possible expansion of existing shared systems in the Integrated Acquisition Environment (IAE). The Agency will prepare a business case and will pursue systems design and development in fiscal year 2008. SBA has put into production automated systems for 8(a), Small Disadvantaged Businesses, and HUBZone applications, and will soon finalize the electronic review and certification processes.

—Expanding the reach to the eTran system, which provides a web-based portal for loans guaranteed through the flagship 7(a) loan program. Seventy percent of our 7(a) loans come in through this portal. Expanding the functionality of eTran will further automate lender interactions. In addition, SBA is working with lenders to identify and address other cumbersome processes, which can deter lenders from marketing certain of SBA's products. The Agency is currently developing a web-based system expected to be used by both surety bonding companies and the small businesses seeking bonding.

—Enhancing its Entrepreneurial Development Management Information System (EDMIS), used by its technical assistance partners, to simplify the system's use and capture better information.

EMPLOYEE ENABLED

The following are actions to keep our employees safe and able to fulfill the Agency's mission:

—*Professional guard services*.—$1.1 million in S&E to support professional guard services, operation of a magnetometer for the building, and training for the guards, in order for the Agency to increase security to the level recommended by the Federal Protective Service.

—*Implementation of government-wide biometric security cards*.—$600,000 in S&E (complemented by about $600,000 in Disaster funding) for the full implementation of Presidential Homeland Security Directive #12, which requires the development and implementation of a government-wide standard for a secure and reliable new identification card issued to Federal employees and contractors. The overall goal of HSPD–12 is to achieve appropriate security assurance by verifying the identity of individuals seeking physical access to Federally controlled government facilities and electronic access to government information systems.

—*Centralized training efforts*.—$550,000 (similar level to fiscal year 2006) for a skills gap assessment for mission critical occupations; an electronic learning

tool; learning management systems; management and leadership development training; a mentoring program; succession planning; and a program to help staff balance the demands of their professional and personal lives.

—*Training for Risk-Related Activities*.—$140,000 to keep procurement and business development staff current on complex changes; $235,000 for training of Regional and District administrative officers authorized to commit funds on behalf of SBA; and $90,000 for training of staff involved in acquisition activities, which are inherently high-risk, Agency-wide.

—*Proactive recruitment*.—$123,000 to attract the necessary skilled personnel needed for succession planning. By 2009, 34 percent of SBA's workforce will be eligible to retire.

—*District Office program oversight staff*.—$100,000 to ensure continued monitoring and oversight of SBDC grant and policy issues, adherence to procedures and knowledge of the program announcement.

—*Enterprise human resources integration system*.—$800,000 to integrate SBA's personnel record keeping into this government-wide record keeping system covering the entire life cycle of Federal employees to replace the current Official Personnel Folder.

OUTCOMES DRIVEN

To fulfill its mission, it is critical that the SBA understand how to drive outcomes aligned with that mission. SBA is proud of its work on budget and performance integration which has allowed the Agency to maintain a green rating in both status and progress since fiscal year 2004.

The Agency recognizes it still has work to do, particularly in defining our programs' outcomes. As such, SBA has contracted with the Urban Institute to analyze our business loan programs with results due in fiscal year 2007. In addition, the Agency is analyzing penetration of its lending products into various place-based and people-based groups to understand their impact more fully.

In Spring fiscal year 2007, the Agency will complete a major review of its Strategic Plan. The review will incorporate information from SBA's financial assistance programs' evaluation, as well as the new SBA leadership team's vision. In addition, reporting, measurement, and goal attainment is being designed to align the most critical outcomes the Agency is working to achieve.

CONCLUSION

In closing, this is a good budget for America's small businesses and America's taxpayers. I look forward to working with you to enact this budget and to help entrepreneurs start, build and grow their small businesses. Again, thank you for inviting me here today and I will be glad to answer any questions.

Senator DURBIN. Thank you very much. I stated at the beginning of this hearing that we have a rollcall, which begins at 9:30. I'm going to ask a few minutes of questions and then turn to my colleagues, Senator Bond and Senator Allard and then, after they've asked those, we will recess until after the rollcall votes when I will return with a longer list of questions, probably around 10:15. I apologize for the interruption but this is beyond our control at this point.

SMALL BUSINESS DEVELOPMENT CENTERS

So let me just say first that I'm concerned, Mr. Preston, about the small business development centers and the amount of money that is being requested in this budget, if this turns out to be a pretty good investment for Federal taxpayers. We spend about $87 million nationwide and according to SBA statistics, we create small businesses that generate five times that amount in Federal tax revenues. So for every dollar that we invest in these centers, businesses are created employing Americans and generating tax revenues at a rate of 5 to 1. That's a pretty good investment.

And yet, there are suggestions here that we are going to cut back on the small business development centers. I'd like for you to ad-

dress this in terms of whether we are, in fact, going to squander an opportunity here to help a lot of people who need help at the expense of business creation. Also, from a minority perspective, we're very concerned about the creation of minority businesses. According to studies commissioned by the SBA, small businesses are the greatest source of net new employment in inner cities comprising more than 99 percent of establishments and 80 percent of the employment in inner cities. However, the 4-year survival rates of minority-owned businesses are lower than the survival rates of non-minority owned businesses. More than one-third of the people who come in to these development centers are minorities. As we cut back, it reduces opportunities for minority expansion for cities and as I mentioned earlier, it reduces the opportunity for businesses to be created, generating tax revenues.

Do you think this is a good choice of expenditures at the Federal level?

Mr. PRESTON. Well, let me just start out by saying two things. Number one, they are a very important part for us. In fact, the small business development centers as well as the women's business centers and our SCORE network are really the cornerstone of our business training and counseling effort at the SBA. And I also acknowledge the criticality of certain minority businesses; in fact, a lot of what we're focusing on strategically right now is how to reach deeper and more effectively into that community because driving small business ownership in the inner city as well as in some of the rural markets where we see difficulty, we think can be an absolute game-changer. So I appreciate the question.

The SBDCs—we are not the primary source of funding for them. We are a core tier of funding that gives them the stability to run a core level of operation, provide overhead, provide hiring to a certain degree but then they also have external fundraising efforts and we encourage them to do that. We are working, in fact, right now with women's business centers on a trial basis to help them become more effective in external fundraising and to bring best practices to bear and we would like to have that type of a dialogue with the SBDCs as well.

So I guess, Senator, I look at it as we are a very significant layer of funding to them. We enable them to go and do things that they might be able to do otherwise but we would like to work with them and encourage them to expand their external funding sources because we do think that expanding their reaches is important.

Senator DURBIN. I know that you've testified to that before but I think that you're overlooking the fact that that Federal investment is an incentive for non-Federal sources and as we back off of it, I hope that you're right but we may be wrong, at the expense of a lot of opportunities. I'm going to leave at this point and turn it over to Senator Bond and you'll have a 5-minute clock and then turn it over to your colleague, Senator Allard and Senator Allard, if you could stay that long, if you'd be kind enough to recess the hearing at the end of your question and we'll resume at about 10:15.

Senator BOND [presiding]. Thank you, Mr. Chairman. Senator Allard can run faster than I can so we will—you're younger and in better shape.

Congratulations, Mr. Preston, to you and Ms. Carranza, on the successes. I'm hearing very good things about the SBA under your leadership and the revitalization.

Mr. PRESTON. Thank you.

SMALL BUSINESS INNOVATIVE RESEARCH

Senator BOND. But there are a couple of areas I want to highlight very quickly with respect to procurement. The performance budget states there will be a review of the small business innovative research, SBIR, and the small business technology transfer, STTR programs. Based on these reviews, SBA will recommend legislation and propose regulatory changes. It goes on to state the SBA will continue to improve oversight and evaluation of SBIR and STTR. As we all know, they function more than simply as procurement. SBIR was created in the 1980s, to provide new contracting opportunities for small companies and to foster innovation and commercialization of innovative products by small companies.

The National Institutes of Health SBIR program, for example, helps small medical device, biotech, and diagnostic firms access critical early-stage capital to get the product off the drawing board and I continue to be concerned that SBA is stifling innovation in biotechnology and other industries relying heavily on venture capital. Biotech industry is heavily dependent upon capital expenditures, 10 to 15 years, $800 million for a company to bring just one product to market.

For 20 years until 2004, your agency was a catalyst for developing America's most successful companies, helping to fund startup and development. But then SBA decided that small businesses was relying heavily on venture capital no longer qualified for SBIR and that inequitably penalized biotech firms and has delayed, maybe even prevented life-saving drugs and life-enhancing medical innovations and I believe in certain circumstances, has driven them abroad.

Last year, I offered legislation to correct it. It was included in the SBA reauthorization, which fell victim, like everything else, to the delays and filibusters at the end of the session. I might also note, I'm equally concerned about this administration's continuing lack of enthusiasm for the HUBZone program. Ten years ago as chairman of the authorizing committee, I wrote the legislation authorizing the historically under-utilized Business Zones or HUBZones, to provide incentives for companies to locate and provide jobs in the Nation's inner cities and depressed areas by giving them a Government contracting preference. As you yourself have just said, there is still a great need for good jobs in the distressed areas of big cities and small towns and I'll look forward to working on that with you.

But one point I want to make. I have this chart that came from NIH and it shows the base application rates for the SBIR program and the RO1 program. This is significant because it shows when the new regulations were applied to a specific company, Cognetixs, in 2003 but the agencies did not fully implement them until 2004. So it's fair to say that these 2005 and 2006 numbers where the application rates fell off significantly in percentage terms, are a result of the venture capital rules. And the chart also includes the RO1

applications, the largest NIH grant program for universities and academia. So while the SBIR program was falling off, it shows that applications for the RO1 grants continued to increase. I think this makes a very strong case to show that the decrease in SBIR applications is specific to the SBIR program and not a result of scientific trends. Would you agree with that?

Mr. PRESTON. Well, I would certainly want to dig into the data further, Senator, to understand what it implies. One of the things we have, we are waiting right now, is a study from the National Academy of Science that looks at the whole SBIR program and the value of it, et cetera, et cetera. I do agree, it's a critical program for getting capital to companies that are involved in the commercialization stage that are small. Venture capitalists can own up to 49 percent. I think your point is based on the need of the funding. It may need to go over that.

What we're trying to do here is balance the need to get money to small businesses that are viable and have great ideas with ensuring that we get the kind of value out of the program that you're talking about.

Senator BOND. I look forward to discussing that with you further and I'll leave my further questions for the record and turn you over to the tender mercies of the Senator from Colorado.

Mr. PRESTON. Thank you.

Senator ALLARD [presiding]. Thank you, Senator Bond. I appreciate it. I ask unanimous consent that my full statement be a part of the record.

Senator BOND. Without objection.

[The statement follows:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Durbin for holding the first hearing of the new Subcommittee on Financial Services and General Government. I was fortunate to work with him as my Ranking Member on the Legislative Branch Subcommittee during the previous Congress, and I look forward to continuing to work with him in this new capacity.

I am pleased to be a member of this new subcommittee. These agencies are of a particular interest to me, as I am ranking member of the authorizing subcommittee with similar jurisdiction. I appreciate this opportunity to become more involved in their budgetary matters as well.

Coming from an agricultural state like Colorado, I have a keen interest in the Commodities Futures Trading Commission. I will be eager to hear how the CFTC is changing with the financial markets.

I hope Chairman Jeffery will also be making a few comments on the topic of competitiveness. Following the release of the Paulson report and the Schumer/Bloomberg report, competitiveness of the capital markets has become the primary topic of discussions in the financial markets. While most of the discussion focuses on more traditional securities, I am curious to hear more about how futures, options, and the CFTC fit into the picture.

I also hope that Chairman Jeffery will discuss the proposed new transaction fees. This would be a major shift, and I believe it is important to fully understand all aspects of the proposal.

I also look forward to hearing from Administrator Preston of the Small Business Administration. I started and owned a small business, so I am well aware of the challenges faced by small businesses. Once an entrepreneur is able to overcome the hurdle of raising the necessary start up capital, the new business owner faces daunting rules and regulations. The SBA is an important resource for help with both.

It is important that we continue to promote the start up and growth of small businesses in America, since they are a significant sector of the economy.

Small firms

—Represent 99.7 percent of all employer firms.
—Employ half of all private sector employees.
—Pay more than 45 percent of total U.S. private payroll.
—Have generated 60 to 80 percent of net new jobs annually over the last decade.
—Create more than 50 percent of nonfarm private gross domestic product (GDP).

I would like to thank Chairman Jeffery and Administrator Preston for appearing before the subcommittee today. Your perspective will be very helpful as we move forward with your budgets, and I look forward to your testimony.

LOAN OVERSIGHT

Senator ALLARD. I have two quick questions. You have an inspector general report where it says the agency does not have sufficient controls to detect fraud and prevent unnecessary losses. What is your response to that critical statement?

Mr. PRESTON. I think the agency does have sufficient resources. We've significantly increased our lender oversight. We've expanded that group. We've expanded the statistical tools that we use to analyze our lenders. We actually continue to see improvements in the improper payment numbers and I think we've got a great working relationship with our inspector general on these issues. So I think we continue to improve. In fact, right now——

Senator ALLARD. Are you watching your loans on your businesses and being careful—being sure they don't get in some of these exotic loans that we're seeing in the housing market?

Mr. PRESTON. Senator, our loans are set up in very specific programs. So there are only certain kinds of loans we can make.

Senator ALLARD. They are 50 year, 30 year standard payoff loans.

Mr. PRESTON. They generally are even shorter than that.

Senator ALLARD. Okay.

Mr. PRESTON. But mostly they are bank loans that have to fit into a particular framework.

PART

Senator ALLARD. Okay. Very good. The other thing, too is I take a lot of interest in the PART program. Do you know what I'm talking about? It deals with setting goals and objectives that are measurable and examining outcomes.

Mr. PRESTON. Exactly.

Senator ALLARD. There are a few programs under your purview that I don't think quite made the grade on that PART program, maybe just one or two or three. Do you want to comment on that?

Mr. PRESTON. I probably prefer to work with your staff to find out specifically which programs you're considering but we do have PART goals on all of our programs, you're correct, yes.

Senator ALLARD. I'm one that follows that.

Mr. PRESTON. I think that's very important.

Senator ALLARD. I say that just to alert you that whenever you show up in front of me, I'm liable to ask you about the PART program. If you have some programs in there that are lagging in that regard, you'll get some questions from me on that.

Mr. PRESTON. Great.

Senator ALLARD. So you need to be prepared because I think the Government Performance and Results Act has got the right tone

that we need to bring accountability to our agencies. I'm one that believes in that so you'll hear some questions from me on that.

Mr. PRESTON. That's great. I agree with you fully. Thank you.

Senator ALLARD. Very good. You know, I'm not sure you've got any but it seemed like there might have been one or two there. But if not, don't worry about it. If there is, I'd like to get a response to my staff on where you are on those particular programs.

Mr. PRESTON. Great.

Senator ALLARD. I need to go down to the floor and catch this vote, so I'm going to put the subcommittee in recess.

Mr. PRESTON. Great. Thank you.

MICROLOANS

Senator DURBIN [presiding]. Sorry for the delay and I thank you for your patience, Mr. Preston. We got a few things done on the floor. I'm sorry if some of this area, some of these questions have been covered but I'd like to ask, if I might, why your budget request this year proposes that the microloan program be operated through higher interest rates and with zero subsidy. You also proposed to eliminate all technical assistance funding for microloans. Explain to me if you can, how the SBA came up with the statement that it cost 85 cents to make a $1 microloan and whether that calculation takes into account the ongoing cost of intermediaries providing technical assistance and support to businesses and their portfolio?

Mr. PRESTON. It does, it takes into account two things. It takes into account the technical assistance piece, which is really the primary on it there. I believe the technical assistance piece is $13 million of the cost and then a much smaller portion, somewhat over $1 million, represents the subsidy that we currently pay on the loans that we make to the microlenders. So in other words, that's the degree to which the Government subsidizes those loans because we offer them below the Treasury rate.

Senator DURBIN. What is the total dollar amount the SBA currently has in outstanding loans to microlending intermediaries?

Mr. PRESTON. Outstanding—I don't have that number at the top of my head. I know last year we made about $18 million in new loans. I can get that for you in a second.

Senator DURBIN. Do you know what the average amount of a microloan is?

Mr. PRESTON. In that program, I believe it's $13,000. It maxes out at $35,000.

Senator DURBIN. Could you kind of describe the typical recipients?

Mr. PRESTON. The typical recipients of ours, in many ways, are our target group. They are heavily represented by minorities. They reach into the inner cities as rural markets. And there is a heavy representation of women as well.

Senator DURBIN. Which, if I remember from your other testimony, is a high priority for the SBA.

Mr. PRESTON. Exactly. Yes, it is.

Senator DURBIN. So I asked you earlier about the small business development centers, which we understand are used not exclusively but disproportionately by minorities and now we find the microloan

program, which is being cut back. Do you see, from my side of the table, that it looks like you're stating your goal is to reach out to these people and yet your budget says that you won't?

Mr. PRESTON. Well, I think what we're trying to do is expand the capital that we can get out there and try to do it on a cost-effective basis. We're asking for authorization of up to $25 million—I think last year, we put about $18 million out there and what we'd like to do is be able to put more money out there but put it out there on a most effective basis.

Senator DURBIN. I'm interested in that cost effective phrase that you just used. If you don't offer as much in microlending, is it not true that those who are seeking the loans will turn to the commercial side, which may be more expensive?

Mr. PRESTON. I think by increasing our cost to the microlender, there will be some increased cost to the borrower. I also think though, there are a lot of microlenders out there that don't take—avail themselves of our funds and we're hoping that by expanding the capital available to microlenders, we'd actually be able to get more capital in the hands of people.

Senator DURBIN. But isn't technical assistance a critical part of this?

Mr. PRESTON. It's absolutely critical.

Senator DURBIN. To make sure the microloans are based on a good business plan, executed well, monitored carefully?

Mr. PRESTON. Yes, it's a necessary component. It's critical but we, Senator, already provide technical assistance to about 1½ million people a year. We have 13,000 counselors in our network and this is 2,500 loans each year. So we're looking to leverage that network to provide that technical assistance to these people. It is a fraction of 1 percent relative to the volume that we already undertake.

Senator DURBIN. I understand you have many people who are involved in small business development centers, SCORE volunteers and SBA technical assistance providers, who step in to assist businesses that receive loans from microlending institutions. I'm not convinced though, that these other technical assistance providers can really provide the same intensive and personalized assistance that microlenders currently provide their own borrowers. Unlike a lot of the SBA technical assistance providers, microlending intermediaries reach out to their borrowers and proactively check to see if they need assistance and what needs they might have. The SBDCs and SCORE volunteers respond to businesses that contact them seeking help. So it's a much different relationship. It's a proactive relationship with the microlending intermediaries and one that is more passive when it comes to these other sources.

Mr. PRESTON. I think that is a fair representation of the majority of the people they work with. I don't know that I would concur that a lot of these people don't reach out and honestly, I've spent many, many days in the field, talking to small businesses that have worked both with our district offices and with the SBDCs and other volunteers and the tight relationship, the consistent interaction, in many cases, is there.

DISASTER LOANS

Senator DURBIN. Let me move to another topic, disaster loans. What is your estimate for disaster loan activity in the next fiscal year?

Mr. PRESTON. We've got $1.064 billion in our budget request.

Senator DURBIN. And how did you arrive at that estimate?

Mr. PRESTON. That is derived from a 10-year average. Ten-year average, accepting the outlayer years, which is, I believe, primarily Katrina.

Senator DURBIN. In the recently passed continuing resolution, we provided the SBA an additional $113 million for disaster loan administrative costs for 2007.

Mr. PRESTON. That's right.

Senator DURBIN. How long do you project the program can operate with that amount of additional funding?

Mr. PRESTON. Based on the estimate for a typical disaster year, which never actually occurs, obviously, that would take us well into July, which would leave us short for the last few months. If we would have a year where there was somewhat lighter disaster activities, it's conceivable we could get through the year and certainly if it's a heavier year, that would be an issue.

Senator DURBIN. So what happens if you run out of money in that area in July?

Mr. PRESTON. If we run out of—if we purely run out of money in July, we don't have money to fund new disaster loans in the program and I just want to mention, the money that we have that came through the continuing resolution is less than what we requested in the process. I believe we requested $140 million, which we thought would take us through the full year.

Senator DURBIN. To your knowledge, will there be an additional request on the supplemental?

Mr. PRESTON. I know we are working with your people on the supplemental.

Senator DURBIN. Okay. Your budget justification talks about the fundamental re-engineering of the disaster loan program and the creation of a disaster reserve. What do you have in mind?

Mr. PRESTON. Well, we've already made a tremendous amount of progress and I would invite you or anyone on the subcommittee to send staff down to our processing center and we'll take you through in detail what we've done. But we have fundamentally restructured the operational processes around how loans are distributed and closed and we continue to drive kind of a—it's a very deep re-engineering, Senator, so it's—I don't want to get in the weeds too much but effectively to put in place processes to make our people more responsive, to give them better customer service along the way, to get loans and approvals processed much more quickly. And it really gets into digging very, very deep into the operational processes and basically fixing some things that were broken.

AGENCY STAFFING

Senator DURBIN. I wanted to ask for a moment about agency staffing levels. We understand your staffing levels have declined significantly over the past several years, though you've only been

there 8 months so some of this precedes your arrival. Can you provide us with a chart for the record, showing the agency staffing levels by year for the past 5 years?

Mr. PRESTON. We can do that.

[The information follows:]

EMPLOYMENT SUMMARY

[Headcount: Based on the HCM Employment Summary Report]

	9/30/02	9/30/03	9/30/04	9/30/05	9/30/06	12/31/06	Fiscal year 2008 budget
Headquarters:							
Executive Direction	239	257	249	248	230	231	.....
Management and Administration	95	92	92	94	95	94	.....
Chief Information Officer	53	53	53	53	48	52	.....
Capital Access	159	157	137	132	129	133	.....
Entrepreneurial Development	46	49	45	43	42	41	.....
Government Contracting/Bus Dev	91	89	74	69	73	72	.....
Total headquarters	683	697	650	639	617	623	.....
Field:							
Field Support to Headquarters [1]	257	258	253	250	246	340	.....
Field Servicing Centers	86	83	150	151	158	164	.....
Regional Offices	23	26	27	32	31	29	.....
District Offices [2]	1,674	1,581	1,294	1,053	1,002	899	.....
Total field	2,040	1,948	1,724	1,486	1,437	1,432	.....
Total SBA funded employees	2,723	2,645	2,374	2,125	2,054	2,055	2,123
Inspector General	108	98	97	94	102	104	.....
Disaster Loan Making	854	733	1,855	2,240	4,083	3,460	.....
Disaster Loan Servicing	205	159	142	115	101	98	.....
Total SBA employment	3,890	3,635	4,468	4,574	6,340	5,717	.....

[1] Field Support to Headquarters includes Legal staff in District Offices, the Denver Finance Center, and Regional Advocates plus others. A complete listing is available upon request.

[2] The decrease in headcount reflects a reclassification of 91 legal staff from District Offices to Field Support to Headquarters.

Senator DURBIN. Are you concerned that staffing levels have dropped too far, where you can't meet your statutory obligations?

Mr. PRESTON. I'm not. I want to tell you once again, we're particularly heartened by the work you all have done with us for 2007 and with the budget in 2008 because that will allow us to add about 86 people, which I think will be very important for us. We are at a tight level right now but I'm not concerned about our ability to meet statutory requirements.

Senator DURBIN. The Office of Personnel Management (OPM) Survey of Government Employees indicated that a significant number of SBA employees felt they didn't have sufficient resources to do their jobs. How will your budget request provide adequate resources?

Mr. PRESTON. Unfortunately it showed a lot more than that, many of which—many of the items showed that we have a lot of work to do in our employee base. Our people are not trained well enough right now. They are not all allocated to the right activity and we are going through an extensive review right now. We're about to roll out extensive training programs. We're clarifying roles and responsibilities of people throughout the agency to make them

more effective in meeting the needs of the agency. And all of that is very specifically responsive to the OPM tool as well as some surveying that we've done on the side. I also have personally been to many of our district offices and talked with our people.

Senator DURBIN. I just wanted to say—you mentioned at one point in your budget justification a morale problem among the employees.

Mr. PRESTON. Pardon me?

Senator DURBIN. You mentioned a morale problem among employees.

Mr. PRESTON. Yes. It was in the 2004 survey and it was validated by the 2006 survey that was completed in June. So I'm getting a little ahead of things here but in the coming year, every one of our district offices will be goaled on people initiatives, which will include career planning, training, GAP assessments, reviews—all sorts of things that I think are critical. The last thing you want in a service organization is bad morale. So this is something we have to nail and something frankly, I take very personally.

CONTINGENCY PLANNING

Senator DURBIN. I have a series of questions I'd like to submit to you for the record but I want to close by asking you about some of the concerns expressed by the inspector general's office. Concerns were expressed about whether the SBA has devoted sufficient resources to develop comprehensive contingency planning so that it will be able to respond in a quick and effective manner to large-scale disasters, similar to gulf hurricanes. What resources does the SBA budget request allocate toward large-scale disaster planning?

Mr. PRESTON. Well, we are—that is an ongoing responsibility of the senior leadership team for the disaster business but right now we have a very significant team focused both on re-engineering the process, which I mentioned earlier as well as building a detailed sort of disaster search plan that would effectively be like a playbook that you could—that we would be working with to show exactly how we ramp in a major disaster. So I believe the budget we have in place is sufficient to be able to do that but clearly, if a significant disaster hit, we would need to come back for additional funding to handle the scale of the volume.

Senator DURBIN. I understand that part. Funding may be necessary but I guess the question is whether you have a contingency plan so that if you—in the Hurricane Katrina situation, we had some warning. Not much but some and I think it really put all the Federal agencies on notice if they have to respond to a disaster, to think large. Be prepared. Have you done that?

Mr. PRESTON. Yes, we have and I think a lot of the capacity expansion has already happened. The systems capacity is threefold to fourfold what we used in Katrina. We're building a very significant reserve force, which are people that are pre-trained. We will be rolling out in the next couple of months, a training program that will go across all of our district offices, which currently don't exist—don't work with the disaster business. So a lot of the money we have in training and some other areas will be used to support that.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. I thank you very much and thanks for your patience. I'm sorry we had to interrupt the hearing and glad that we got the questions in. We'll be working with you on next year's budget, trying to make sure that we provide you the resources the Small Business Administration needs. Thank you.

[The following questions were not asked at the hearing, but were submitted to the agency for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

Question. Mr. Preston, as you see it today, what are the most significant problems currently facing the SBA?

Answer. Since joining SBA I have spent a significant amount of time listening to employees, partners, and most importantly, customers. I have reviewed many of the Agency's programs in order to identify how to build on SBA's successes and address the areas needing improvement. When I came to the Agency, many of our most critical positions were vacant, and some key management processes were broken. I continue to work to build a team of competent leaders and managers, which will be essential in addressing our challenges and opportunities.

My views are grounded in a belief that we can improve the effectiveness and impact of SBA's programs and activities markedly, and therefore our impact on Small Business, by employing important management principles: Focusing on the needs of the customers; Driving outcomes important to our country; and Operating in a compliant, efficient and transparent manner.

Question. To what extent does your 2008 budget request enable you to address these problems?

Answer. The fiscal year 2008 budget request provides ample funding to reform and refocus the Agency so that SBA is able to fulfill its mission to help America's entrepreneurs start, build and grow their small businesses. This funding will support:

—Continued reengineering of the loan servicing process, resulting in better customer service and less operational redundancy. Further, consolidation of 7(a), 504 and Disaster loan liquidations will ensure that loans are managed more consistently and efficiently;

—Sharpened focus on the country's most underserved communities through expansion of the Community Express pilot, the Urban Entrepreneur Partnership, business process reengineering for the Office of Government Contracting and Business Development (GCBD), expansion of Alternative Work Sites, and expanded veterans' outreach, among other priorities.

—A more accountable, efficient and transparent organization through centralized loan operations, operational assessments, an improved loan liquidations process, enhanced lender oversight, and other important initiatives.

Question. To what degree does SBA depend on contracts with information technology providers to administer its disaster loan program? Are you confident that your agency's oversight of these contractors is sufficient?

Answer. There are two primary IT support contracts supporting the Office of Disaster Assistance for its mission critical IT system, the Disaster Credit Management System. The total contract staff represents approximately 50 percent of the ODA's resources performing IT functions at our DCMS Operations Center. SRA, International provides IT support and resources for maintenance of software, network, applications, database, help desk, and project management. IBM is under contract for critical system hosting services with service level agreements for system and network availability and security.

Contract oversight of the service providers by SBA management is proactive and adequate to achieve the objectives of the mission. Planned improvement to system functionality and reliability are on-going activities. The results are consistently successful implementation of these enhancements within the schedule and budget allocated.

Question. Legislation has been introduced in this Congress to allow banks to make SBA-guaranteed disaster loans. What is your agency's position on this legislation?

Answer. SBA is working with banks and other entities to develop a role in the private disaster lending arena. While the current language being proposed is much improved as it gives SBA more flexibility in crafting a workable proposal, we are continuing our discussions with the banking industry. It is important to understand

that this would require a solid plan that balances the needs of disaster victims, the role of the private sector and the Agency's duty to manage the risk to taxpayer funds.

Question. What is the size of your current outstanding loan portfolios in your various programs?

Answer. The table below reflects outstanding principal balances for all of SBA's large loan programs including pre-credit reform era loans as of September 30, 2006.

OUTSTANDING PRINCIPAL BALANCES AS OF 9/30/2006

	Amount
7(a) Business Loans	$46,137,567,613
504 CDC	16,736,723,758
SBIC Participating Securities	4,818,789,740
SBIC Debentures	1,988,225,000
All other programs	1,484,135,591
Total	71,165,441,702
Disaster	6,806,142,230
Microloan Direct	92,330,700
Total Portfolio	78,063,914,632

Question. What procedures are used to provide oversight of lenders and monitor loan performance for your guaranteed loan portfolio? Do you think these procedures and your capacity are adequate?

Answer. In fiscal year 1999, SBA formally recognized the need for greater oversight and risk management of SBA's lenders and loan portfolios, creating SBA's Office of Lender Oversight (OLO). Since that time, OLO has implemented numerous procedures to provide oversight of 7(a) Lenders and Certified Development Companies and to monitor loan performance of the 7(a) and 504 guaranteed loan programs. In Today, OLO continues to implement and improve SBA's monitoring and oversight processes.

The procedures OLO has put in place have taken several forms. The following is a highlight of key procedures. OLO has established a system of risk management through the development of an off-site monitoring and review system for all 7(a) and 504 loans and SBA Lenders that has been recognized as an "industry best practice." OLO has also strengthened on-site reviews and exams of SBA's larger SBA Lenders. OLO has increased interoffice coordination and communications on oversight of high-risk SBA Lenders, though formation of interoffice lender oversight and portfolio analysis continues. Finally, OLO is in the process of implementing other initiatives that will add to its oversight capabilities a more detailed discussion of SBA's Lender and loan oversight procedures and processes follows.

Loan and Lender Monitoring.—System Off-site monitoring is provided through the OLO's Loan and Lender Monitoring System (L/LMS). OLO's L/LMS system was originally developed and implemented in fiscal year 2003. L/LMS enables OLO to perform off-site monitoring of SBA Lenders by providing periodic credit quality and portfolio performance assessments of individual lender portfolios, as well as the overall 7(a) and 504 loan portfolios. L/LMS also uses current and historical performance data to generate predictive measures of future performance. These performance data and predictive measures form the basis of OLO's Lender Risk Rating System.

Risk Rating System.—The Risk Rating System is an internal tool to assist SBA in assessing the risk of each SBA lender's loan operations and loan portfolio. The Risk Rating System enables SBA to monitor SBA Lenders on a uniform basis and identify those institutions whose loan operations and portfolio require additional monitoring or other action.

Risk-based Reviews and Examinations.—OLO has also implemented several measures to improve the quality of on-site SBA Lender reviews and examinations. On-site reviews have been expanded from purely compliance-based reviews into more comprehensive, risk-based reviews. The new risk-based approach was put into operation in fiscal year 2005–06. It includes a review of the SBA Lender's portfolio, its SBA management and operations, and an assessment of the SBA Lender's credit administration policies, in addition to a compliance review. Reviews are generally performed on larger 7(a) lenders and the largest Certified Development Companies (CDCs). Small Business Lending Companies (SBLCs) may receive a more rigorous safety and soundness examination, similar to those performed by federal financial

institution regulators. These safety and soundness examinations include more detailed analyses of some of the same components of the risk-based review; however, the examinations also focus extensively on the financial condition of the SBLC, as measured by the institution's liquidity, capital and earnings strength.

The reviews and examinations are performed by contractors with significant audit experience. Reviews and examinations follow SBA's On-Site Lender Reviews/Examinations SOP. This SOP, published in fiscal year 2006, details review components, procedures, and issues that may lead to review findings. The SOP is available to all SBA Lenders to enable them to understand the review process and help them comply with the requirements of the loan programs SBA contractors receive periodic training covering SBA's on-site and off-site review and monitoring policies and procedures contained in the SOP.

Lender Portal.—The Lender Portal allows SBA Lenders to view their portfolio data online, and compare their performance to the averages of their peers and the overall portfolio. The Lender Portal allows SBA Lenders access to the same information OLO uses to measure risk, and enables the SBA Lenders to be proactive in addressing performance issues rather than reacting to problems after they are contacted. By becoming more proactive in correcting portfolio performance problems, SBA Lenders can reduce SBA's portfolio and SBA Lender risk. Having the Portal information available also assists SBA Lenders in managing their SBA operations and managing their SBA portfolio risk, and can be an important part of their decision to expand their presence in the SBA market.

Corrective Action Plans.—OLO has implemented a corrective action process whereby SBA Lenders work with SBA to address problems and deficiencies identified by OLO through on-site reviews, off-site monitoring and referrals. SBA Lenders are requested to respond to the issues identified and to provide a corrective action plan that addresses the problems. If the institution fails to correct the problem, SBA may then pursue enforcement actions.

Lender Oversight Committee.—Through delegations of authority published in fiscal year 2005, SBA created a Lender Oversight Committee (LOC). The LOC is composed of senior SBA management, as well as OLO management, and meets on a regular basis. Among other activities, the LOC reviews the performance of individual SBA Lenders, and will determine whether to impose certain enforcement actions, as necessary.

Portfolio Analysis Committee.—OLO has also instituted monthly Portfolio Analysis Committee (PAC) meetings. The PAC is comprised of senior and mid-level managers. The PAC reviews overall 7(a) and 504 portfolio performance, trends, and characteristics. The PAC helps ensure that offices throughout SBA are aware of performance activity and potential trends that could affect either loan program.

Coordination with Office of Chief Financial Officer.—As part of the credit subsidy modeling process, the Office of the Chief Financial Officer (OCFO) monitors on a quarterly basis and annually updates purchase and recovery rates for all loan programs. The impact on subsidy rates from changes in purchase and recovery rates are recorded in an analysis of change document that is maintained for all of SBA's loan programs. The CFO attends the monthly PAC meetings. The CFO also provides an analysis of the impact of proposed program changes on the subsidy rates and assists in identifying ways to reduce losses and increase recoveries.

In conclusion, OLO believes that all of the processes and procedures described in this response indicate that SBA has in place a comprehensive system of lender oversight and portfolio monitoring that will reduce the Agency's risk in the 7(a) and 504 loan programs. While capacity in a program of oversight involving over 5,000 SBA Lenders and a portfolio of over $60 billion is always a challenge, SBA is assisted with contract support. SBA has the statutory authority to charge 7(a) lenders fees to cover the cost of oversight including contractor support. This current fee authority along with the CDC fee authority, if enacted should fully support SBA's ability to conduct oversight. SBA has requested similar fee authority for the DCS in the 504 program to ensure that there are adequate resources available to oversee this program as well.

Question. The 7(a) program makes loans available to borrowers who cannot obtain credit at reasonable terms from the private sector without the federal guarantee. Specifically, what borrowers are you trying to reach? How is this purpose affected by the presence of a zero subsidy for the 7(a) program? Would returning to a positive subsidy help you meet your policy objectives?

Answer. The 7(a) loan program is designed for those borrowers who are creditworthy (the lender's analysis concludes that the loan will repay in a timely manner and not default based on historical performance and credit histories) but that either do not meet the lender's collateral requirements, require a longer repayment term

than the lender gives to non-guaranteed borrowers for the same use of proceeds, or are for new businesses with an unproven track record.

When SBA under the Bush administration converted the 7(a) loan program to a zero subsidy loan program for fiscal year 2005, the fees supporting the 7(a) program were returned to their pre-September 11 levels. (After September 11, 2001, fees for the 7(a) program were reduced for fiscal years 2003 and 2004 in the hopes of stimulating the economy that suffered from the terrorist attack.) Prior to that, the fees had been the same since December, 2000. Before December, 2000, the fees under the Clinton administration were higher. Since the 7(a) program became a zero subsidy program, the only fee that has been adjusted slightly upward has been the ongoing annual fee paid by the lender. That fee increased by only 4.5 basis points from 0.50 percent to 0.545 percent during fiscal year 2006. For fiscal year 2007, the fee is 0.55 percent, an increase of only one-half of 1 basis point. And for fiscal year 2008, the fee will decrease to 0.494 percent which will bring the fees for 7(a) below those charged pre-11 when the 7(a) program was subsidized.

SBA believes that for the 7(a) loan program, zero subsidy is still the best policy for the long term stability and growth of the 7(a) loan program. Since the 7(a) program went to zero subsidy, SBA has had two record-breaking years of lending.

Volume during fiscal year 2005 (the first year that the 7(a) program was a zero subsidy program) was 95,900 loans—an increase of more than 18 percent over 2004 when the program was subsidized. Volume during fiscal year 2006 maintained this trend and actually increased by another 1,390 loans. Fiscal year 2007 YTD continues to maintain the strong demand by growing another 9 percent as of March 16, 2007.

Question. What is your default rate in the basic 7(a) program?

Answer. The default rate, as a percent of disbursements, for the 2008 budget submission is 6.96 percent.

Question. What is the default rate in the disaster loan program?

Answer. The default rate, as a percent of disbursements, for the 2008 budget submission is 24.10 percent.

Question. On page 10 of the budget justification, you make this statement: "the agency's entire business loan operation runs on a Cobol-based system developed in-house. Parts of this system are over 50 years old. The system is operated on an expensive mainframe that is dependent on obsolete technology . . .". What are you doing to address this situation?

Answer. We have initiated the Loan Modernization Program to address this situation. We have formed a Steering Council and assigned a Program Manager. We have also submitted the business case (Exhibit 300) for fiscal year 2008 to OMB. The fiscal year 2008 Budget request includes $8 million to start acquiring the solution. Currently, we are in the process of developing the acquisition strategy to identify and implement the solution that will replace the Cobol-based legacy systems.

Question. What other significant information technology (IT) systems are currently under development in the agency and what stage are they in?

Answer.

Loan Management and Accounting System (LMAS).—As described in response to the previous question, the LMAS will support FSIO (JFMIP) compliant loan Origination, Servicing, and Liquidation. The project scope includes an Integrated Financial Management System to support FSIO compliant Loan Accounting. LMAS is a financial management, mixed lifecycle system with the bulk of its development costs scheduled to occur in fiscal year 2008.

Business Development Management Information System "e-application".—The BDMIS e-application will allow the Office of Business Development's 8(a) and Small Disadvantaged Businesses to submit applications for certification electronically via the WEB. This is an enhancement to an existing Business Development system. BD–MIS is mixed lifecycle system and features the e-application within its development segment.

Disaster Credit Management System, E-Loan Application (ELA).—During fiscal year 2007–08, SBA's Office of Disaster Assistance (ODA) is developing an Electronic Loan Application that will integrate with DCMS. One of the ODA's Strategic Management Goals is to offer disaster victims accessible, easy-to-use and time saving services through the electronic filing of disaster loan applications. By using the Internet, ODA plans to transform loan-making into a virtual loan process that provides efficient and timely loan decisions to disaster victims. DCMS is a mixed lifecycle system; ELA represents an enhanced set of capabilities within the development segment of DCMS.

E-Gov Business Gateway.—This is one of 25 E-Gov projects within the President's Management Agenda for E-government. The Business Gateway provides a government-wide one stop website for use by businesses and entrepreneurs. SBA and part-

ner agencies develop tools to assist small businesses seeking to comply with laws and regulations, locate government forms and obtain relevant government information. Business Gateway is currently a mixed lifecycle system planned to be out of the development stage in fiscal year 2008.

Contract Management System (CMS).—CMS will be an information system enabling SBA to perform end-to-end electronic processing of its internal contracts, bringing the Agency into conformance with OMB's E-Procurement guidance. CMS is a mixed lifecycle system planned to be out of the development stage in fiscal year 2008.

Question. The Office of Inspector General's management challenge #1 also identifies flaws in the procurement system that allow large firms to obtain small business awards and agencies to count contracts performed by large firms towards their small business goals. What resources is the agency committing to allow SBA to fulfill a bigger role in ensuring the accuracy of reporting on small business contracting and limiting errors by contracting personnel and fraud by contractors?

Answer. The integrity of the data reported to Congress and the Public is crucial to provide for the confidence in the Federal contracting system. SBA recognizes this, and is taking the lead, along with the Office of Management and Budget's Federal Procurement Policy to work with agencies to ensure their past numbers a scrubbed and future numbers are accurate. The agencies are currently in the process of validating their fiscal year 2005 data to identify the reasons for coding discrepancies and to correct any errors that occurred.

Question. The Office of Inspector General has issued a management challenge finding serious problems with the SBA 8(a) minority contracting program. What resources is the Agency committing to improve this program and address these problems?

Answer. Because the 8(a) Program is a business development program—not a contracting program—it is intended to foster the 8(a) firm's growth (through various forms of technical, management, procurement and financial assistance) and viability during the nine year term. The 8(a) BD Program is for socially and economically disadvantaged entrepreneurs (which include non-minorities) who meet the eligibility criteria.

SBA is committed to improving the 8(a) BD Program and has committed several resources that are aimed at refocusing the Program to emphasize "business development." On September 30, 2006, SBA engaged a contract to conduct a review/assessment of the business processing functions of the 8(a) BD Program (i.e. those processes related to initial certification, continuing eligibility, management and technical assistance, legislative and regulatory requirements) and design a plan consisting of both short and long term methodologies for re-engineering and improving those functions.

Specifically, this process improvement plan will:

—Identify and define each program element and the requirement(s) related to the delivery of the 8(a) BD Program;

—Identify significant issues and problems that exist;

—Identify key issues in the 8(a) BD Program and processes and systems that need to be updated; and

—Review/assess programmatic requirements to ensure relevance and consistency with legislative and regulatory compliance.

In addition, the Office of Business Development conducts monthly training sessions (via teleconferencing) for BD field staff in SBA's district offices. This training (which covers various programmatic and regulatory issues) is designed to improve 8(a) Program delivery and ensure consistency and uniformity as it relates to servicing 8(a) firms.

Finally, SBA is considering various other changes to the program to promote its integrity and efficiency, and the Agency intends to issue a proposed rule to amend its regulations in the near future.

Question. In particular, one of the actions that the OIG has called upon SBA to take is to exert greater oversight over 8(a) contracts issued by procuring agencies since SBA has now delegated authority to those agencies to monitor compliance by 8(a) contractors with SBA regulations and requirements. What resources is SBA devoting towards conducting adequate oversight to ensure that procuring agencies are fulfilling their responsibilities?

Answer. In an effort to ensure greater oversight as it relates to 8(a) contracts issued by procuring agencies, SBA's Office of Business Development has revised the language in the Partnership Agreements (between SBA and the procuring agencies) to clarify roles and responsibilities. The revised Partnership Agreements specifically require the procuring agencies to monitor 8(a) firms' compliance with contract performance. In February 2007, the Office of Business Development began conducting

training for the procuring agencies with regard to rules and regulations governing the 8(a) Program and the revised language in the Partnership Agreements. This training is intended to ensure that contracting officers and technical representatives are adequately advised of their responsibilities concerning 8(a) contract compliance.

Question. The Office of Inspector General issued an Audit Report in May, 2005 on contract bundling. Excessive contract bundling by agencies limit the opportunities for small businesses to obtain government contracts. That report found that SBA had not reviewed 87 percent of the reported contract bundling by procuring agencies even though SBA has a statutory duty to do so, and had not developed a data base to track bundling activity. The report also determined that there was a lack of resources in that the Agency had only 43 Procurement Center Representatives in the entire country to monitor over 2,000 procurement locations for the Federal Government, and that a large percentage of government contracts were not being reviewed by PCRs. What resources is SBA devoting towards addressing these issues?

Answer. The integrity of the data reported to Congress and the Public is crucial to provide for the confidence in the Federal contracting system. SBA recognizes this, and is taking the lead, along with the Office of Management and Budget's Office of Federal Procurement Policy to work with agencies to ensure their past numbers are scrubbed and future numbers are accurate. The agencies are currently in the process of validating their fiscal year 2005 data to identify the reasons for coding discrepancies and to correct any errors that occurred.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. Currently the microloan program costs $0.85 for every dollar loaned. Why is it so costly to administer such loans? How will the program change if it were shifted to zero subsidy as proposed in the President's fiscal year 2008 budget?

Answer. The technical assistance component is a significant factor in the cost of the Microloan program. Subsidized interest rates are another extremely high cost. In addition to Subsidy costs, overhead costs are high since SBA makes direct loans to each microloan intermediary and must continue to process and administer the loan, including additional loan disbursements. The Administration's proposed change in the Microloan program increases the interest rate charged on the loan from 3.77 percent to the microlender to 1.06 percent above the 5-year Treasury rate (estimated in OMB's economic assumption at 4.93 percent). SBA would also eliminate the technical assistance funding for SBA microborrowers, but would provide technical assistance through the Agency's Entrepreneurial Development (ED) resources (SBDCs, SCORE, and WBCs)

The Administration's proposed change in the Microloan program increases the interest rate charged on the loan from SBA to the microlender from 1.25 to 2 percent less than the 5-year Treasury rate (depending on the microlender's average microloan size) to 1.06 percent above the 5-year Treasury rate (estimated in OMB's economic assumption at 4.93 percent).

Question. The fiscal year 2008 budget proposes $484 million in new budget authority. How would this benefit SBA programs? And specifically, what benefits would be passed along to the American Small Business owner?

Answer. SBA's fiscal year 2008 budget request reflects the President's commitment to America's small businesses and the vital role they play in our economy. Enactment of this request will enable SBA to continue serving the small business community while ensuring stewardship of taxpayer dollars.

These resources will support a total of $28 billion in lending authority for small business financing, which represents a potential 40 percent increase over business lending for fiscal year 2006, through the 7(a), 504, and SBIC debentures programs. For its flagship 7(a) program, SBA requests authority for $17.5 billion—a 27 percent increase over the fiscal year 2006 lending level. SBA also requests authority for $7.5 billion for the 504 program, a 32 percent increase over loans made in fiscal year 2006—a record year for 504 lending. Finally, SBA requests an SBIC Debenture program of $3 billion.

In addition, this budget will support the following:

—A disaster loan volume of $1.064 billion (the Agency's ten-year average based upon fiscal year 1996–2005 average activity, excluding the WTC disaster, adjusted for inflation).

—Counseling and training to small business people through SBA's network of resources partners in Small Business Development Centers (SBDC), Service Corps of Retired Executives (SCORE), and Women's Business Centers.

—Assist federal agencies targeting a total of $84 billion in prime federal contracting dollars to be awarded to small businesses in fiscal year 2008.
—Investing in the Agency's human capital through job skills training, mentoring programs, succession planning, proactive recruitment of highly qualified staff, and implementation of an automated personnel records system.
—Maintaining employee security through continued implementation of Presidential Homeland Security Directive #12 and support of major security improvements in the headquarters building.
—Continuing the process of implementing a loan operations system to replace the current outdated system in order to better track payments as well as increase the Agency's loan portfolio oversight.
—Enhancing SBIC oversight and recoveries.
—Providing a cost effective microloan program.
—Continuing efforts to make it easier and faster for small businesses to comply with government regulations.
—Improving SBA products, services and delivery.

Question. What is the $100 million savings to taxpayers stemming from the 7(a) loan program being changed to zero subsidy derived from? Are there other benefits to the zero subsidy program?

Answer. The $100 million savings is an estimate based on the last year (2004) the 7(a) program had a subsidy rate. If the 7(a) program had a zero subsidy rate that year it would have saved the taxpayers about $100 million.

SBA believes that for the 7(a) loan program, zero subsidy is the best policy for the long term stability and growth of the 7(a) loan program. Since the 7(a) program went to zero subsidy, SBA has had two record-breaking years of lending—years not hampered by slowdowns as a result of moving beyond the projected levels prescribed by Congress legislatively.

Question. What is the potential cost to the taxpayers of reducing or eliminating fees on 7(a)?

Answer. Assuming a loan level of $17.5 billion the cost to the taxpayers would be $590 million if all 7(a) fees were eliminated. At the same loan level, the cost to the taxpayers would be $236 million only if the ongoing fee were eliminated and $354 million if only upfront fees were eliminated.

7(A) BUSINESS LOANS FOR 2008

Various Program Levels	Subsidy appropriation needed if:		
	No Annual/Ongoing Fees	No Upfront Fees	No Fees
$17,500,000,000	$236,250,000	$353,500,000	$589,750,000
$16,500,000,000	$222,750,000	$333,300,000	$556,050,000
$16,000,000,000	$216,000,000	$323,200,000	$539,200,000
$15,500,000,000	$209,250,000	$313,100,000	$522,350,000
$15,000,000,000	$202,500,000	$303,000,000	$505,500,000

Question. Does the success of the 7(a) change to zero subsidy have any bearing on the fiscal year 2008 proposal for the microloan program to go to zero subsidy?

Answer. The success of the 7(a) loan program at zero subsidy has influenced this decision, especially since the 7(a) Community Express program has surpassed the Microloan program in loans of $35,000 or less (the definition of a microloan).

Not only does zero subsidy save taxpayers approximately $.85 for every dollar lent under the current microloan program but it expands the opportunities to reach more microborrowers and provide them with more options for counseling and training.

Question. Can you describe in more detail how the new microloan program would work and its benefits (cost and non-cost related)?

Answer. SBA would amortize each microlender's loan at a rate of 1.06 percent above the 5-year Treasury rate (estimated in OMB's economic assumption at 4.93 percent). SBA would also rely on the Agency's ED resource partners (SCORE, Women's Business Centers, Small Business Development Centers) to provide counseling and assistance instead of providing additional grant money to Microlender Intermediaries for technical assistance which represents a savings of $13 million over fiscal year 2006 while actually encouraging a wider variety of entrepreneurial development opportunities. Moving to a zero subsidy in the program would also enable SBA to reach out to a larger number of microborrowers across the country. Microlending intermediaries can still access the numerous other Federal, State and Local grant programs for technical assistance and more intermediaries will be able to leverage the more rare lending program offered by SBA. Currently only 172 of the total 600

microlending intermediaries are registered with the SBA microloan program. This proposal would allow SBA to offer lending opportunities to other qualified intermediaries and reach a wider geographic area and market.

Question. How many microlenders are in close proximity, or co-located, with other small business counseling centers receiving federal funding?

Answer. SBA doesn't have information on the locations of all small business centers receiving federal funding, but based on an analysis of the locations of the centers that SBA funds, almost all (about 95 percent) of the Agency's microloan intermediaries are located within close proximity to an SBA ED resource partner, which include SBDCs, WBCs, and SCORE. In addition, SBA believes the approximately 10 intermediaries not located in close proximity to an SBA small business counseling center could be served by circuit rides established by SBA's existing resource partners.

Question. Do microlenders receive funds from other sources? If so, what are they and how much of their funding comes from government sources?

Answer. SBA has not evaluated the alternative funding sources available to SBA's microloan intermediaries or to the microloan industry as a whole. However, according to 2005 information developed by the Association for Enterprise Opportunity, the leading trade association for the industry, in association with the Aspen Institute, there are about 18 federal sources of funding for the microloan industry and undoubtedly a number of state sources.

Question. How would Senators Kerry, Snowe, Landrieu and Vitter's proposal for a private guaranteed lending programs for the regular 7(b) loan program in S. 163 affect the disaster subsidy rate and funding needs?

Answer. CBO estimated that an identical proposal in S. 3778, that the estimated subsidy rates for the different types of business loans and loan guarantees offered by SBA currently range from zero for 7(a) and section 504 programs to about 17 percent for the NMVC program. Incorporating program amendments in this bill and using historical demand and default rates for those loan programs, CBO estimates that the subsidy costs for the authorized levels of guaranteed and direct business loans would be $23 million in 2007 and about $128 million over the 2007–2011 period.

Question. How much would the Energy Emergency Loan Program in S. 163 cost?

Answer. *Section 402, Small Business Energy Emergency Disaster Loan Program*.—Based on the information provided, and the proposed loans are funded within SBA's existing Disaster Assistance direct loan program, it appears this proposal will not impact the subsidy rate.

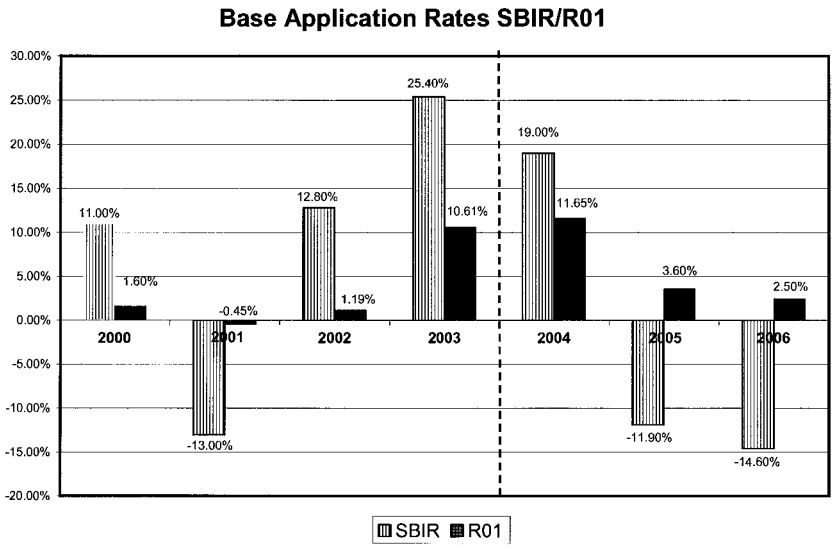
Section 403, Agricultural Producer Emergency Loans.—It appears USDA would provide funding for the proposal but the legislation does not provide sufficient information to estimate the impact on SBA's Disaster Assistance program subsidy rate.

Question. How much would the Energy Emergency Loan Program in S. 163 cost? CBO says it would cost approx. $85 million (subsidy and admin) 2007–2011.

Answer. We estimate that the administrative cost would be approximately $50 million.

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

Question. With respect to the SBIR program: As I mentioned earlier, I am concerned that we are shooting ourselves in the foot by limiting biotechnology companies' access to this program. We recently received this data chart from NIH. It shows that for the last 2 consecutive years, the number of applications to NIH's SBIR program has decreased. This is significant because the new SBIR rules were first applied to a specific company (Cognetix decision) in 2003, but the agencies (such as NIH) did not fully implement them until 2004. So it is fair to say that the 2005 and 2006 numbers represent the first 2 years that the new restriction on venture capital financing has been fully in effect. Look at the impact on applications at NIH.



The chart also includes figures for R01 applications. I am told that it is the largest NIH grant program to universities and academia. So while applications for NIH's SBIR program fell significantly in 2005 and 2006, applications for R01s continued to increase (albeit at a slower rate than previously). Would you agree this makes the case that the decrease in SBIR applications is specific to something going on with the NIH SBIR program and not a result of scientific trends or some other outside factor?

Answer. The Small Business Administration is currently reviewing the issue of venture capital investment in firms that compete for SBIR awards. The National Academy of Sciences is conducting a study on the SBIR program and expects to issue its report in the coming months. This is an important issue concerning the SBIR program. As such, the Agency will review as it addresses this issue.

Question. Mr. Preston, as you evaluate the SBIR program with an eye toward regulatory or legislative changes, I urge you to look at ways to ensure that the most innovative small firms—including those that raise private funds, such as venture capital—are able to participate in the program. The SBIR authorizing statute listed the raising of private funds by a company as a positive factor that agencies should take into account when awarding SBIR Phase II grants. Congress viewed raising private research funding as a good thing in 1982; that has not changed.

As America's high-technology companies compete for funding in an increasingly global marketplace, the ability to attract and retain capital has become more important than ever. The SBA should not discriminate against good science by small entrepreneurial companies simply because they have been successful in raising venture capital.

Are you willing to work with us to address this problem administratively, so that a legislative fix will not be necessary?

Answer. We would be happy to discuss this issue with you prior to making a final determination.

Question. With respect to the HUBZone program: Our agencies have never achieved the 3 percent minimum mandatory HUBZone contracting level, yet the fiscal year 2008 funding for the HUBZone Program has been reduced to $8.79 million from an fiscal year 2007 level of $9.077 million. Why are the funds for this vital program that focuses on the underserved areas of our Nation continually reduced?

Answer. The bulk of the HUBZone Program's funding request is spent on support provided by the SBA district office staff. The services these district office personnel, known as liaisons, provide is twofold. They conduct marketing outreach to the local community and execute the in-depth program examinations that ensure only qualified firms receive HUBZone benefits. Program examinations are executed on approximately five percent of the portfolio and supplement the program's alternate continuing eligibility tool—HUBZone recertification.

A smaller portion of the request ($2 million) supports the Headquarters staff who are responsible for policy development, certification and eligibility, adjudication of protests as well as maintenance and technological advancement of the HUBZone system. What these funds produced most recently are two online systems dedicated to increasing HUBZone contracts. One system scrubs each day the contracts listed in FedBizOpps and, if it identifies a suitable non-HUBZone contract, a letter is sent to the responsible contracting officer asking that the contract be reclassified as a HUBZone set-aside. The second system, when fully deployed will allow HUBZone certified concerns to generate requests to contracting officials that contracts contemplated in the near-future be reserved for HUBZone firms. It is anticipated that these two internet based tools will increase contracting opportunities for HUBZone firms and assist agencies in achieving the 3 percent statutory goal.

The HUBZone Office is continuing to enhance its multiple systems through the use of high-end technology. The cost savings brought about by the efficient application of technology is reflected in the Administration's ability to decrease the fiscal year 2008 budget request.

Question. The SBA 2008 budget eliminates the separate line item for HUBZone funding. Why is this no longer a priority program for the Administration?

Answer. As seen in Table 6 of SBA's fiscal year 2008 budget request, Note 2 states that funding for the HUBZone program is included in the GCBD Operating Budget. This is the same method of budgeting used for the 8(a) program. For HUBZones, SBA is seeking $888,000 plus a staff cost of $1.1 million each year. Our overall financial spending on the HUBZones program is approximately $9 million. SBA has proposed eliminating a line item that does not accurately reflect our commitment to the program and inhibits the agency from exercising flexibility in its budget. The SBA considers HUBZones a vital part of overall procurement effort.

QUESTION SUBMITTED BY SENATOR RICHARD C. SHELBY

Question. I know there were problems with the Small Business Administration conducting its normal loan business, while addressing loan needs stemming from the impact of Hurricane Katrina. Has this issue been resolved?

Answer. The 2005 hurricanes which hit the Gulf Coast were the largest natural disaster in the history of the SBA. This required an unprecedented response from the Office of Disaster Assistance as well as the dedicated staff throughout the Agency. In response to the Gulf Coast hurricanes, SBA processed over 420,000 loan applications for homes and businesses.

During the same time period, the SBA guaranteed a record number of loans under its two primary small business loan programs, setting records for both the number of loans and the dollars loaned.

So while the Agency certainly experienced some strains and was stretched thin to respond to the overwhelming disaster caused by Hurricanes Katrina, Rita and Wilma, it is safe to say the team at SBA worked hard to overcome these and focus their efforts on serving our small business customers.

SUBCOMMITTEE RECESS

Mr. PRESTON. Thank you very much.

Senator DURBIN. Thanks to all your people who are with you here today. This meeting of the subcommittee stands recessed.

[Whereupon, at 10:35 a.m., Friday, March 9, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

WEDNESDAY, MARCH 21, 2007

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3:20 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin and Allard.

THE JUDICIARY

STATEMENT OF HON. JULIA S. GIBBONS, JUDGE, U.S. COURT OF APPEALS, SIXTH CIRCUIT; CHAIR, BUDGET COMMITTEE, JUDICIAL CONFERENCE OF THE UNITED STATES

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. I'd like to note that this is the first hearing on the judiciary's budget before this subcommittee since 2002.

This afternoon, we will be hearing from two distinguished witnesses, Judge Julia Gibbons and Director James Duff. I'm pleased to welcome Judge Gibbons, Chair of the Judicial Conference's Budget Committee, as well as Mr. Duff, Director of the Administrative Office of the Courts.

And I welcome my colleague, Senator Allard, who has joined me today, and others who may arrive.

For the past 3 fiscal years, the judiciary has achieved approximately a 5-percent budget increase, which has helped put the courts back on track after suffering significant cuts in fiscal year 2004. I'm pleased this subcommittee was able to increase funding for the judiciary in critically needed areas during this fiscal year despite operating under a continuing resolution.

With these fiscal year 2007 funds, the judiciary will be able to make progress in dealing with the increased caseload in areas like the Southwest border, prevent termination of 2,500 employees, ensure payments for constitutionally guaranteed criminal defense services, prevent discontinuation of civil jury trials prior to the end of the fiscal year, and address the courts' security needs, a top priority of mine.

FISCAL YEAR 2008 BUDGET

For fiscal year 2008, there's a request for a 7.6-percent increase overall for the judiciary above last year's level. In addition, there's a request for an increase in the noncapital panel attorney rate, which would permit hourly rates to go from $94 to $113. The subcommittee will need to consider that carefully. I'm aware that in recent years the Judicial Conference undertook cost-containment measures, and, as a result, you were able to reduce some costs. I know your testimony discusses this, as well as additional cost-saving efforts underway.

Regarding court security, I understand you've had some problems with the ability of the Federal Protective Service to adequately safeguard the exterior perimeter of all courthouses. I want to hear more about that.

NATIONAL ACADEMY OF PUBLIC ADMINISTRATION REPORT

Recently, the National Academy of Public Administration (NAPA) conducted a study of the judiciary's budget processes and how the judiciary prepares for the future. NAPA had some recommendations, which I will also be anxious to hear your response to.

I look forward to discussing these and other issues. I note the subcommittee is in receipt of written testimony submitted by the Court of Appeals for the Federal Circuit, Court of International Trade, Federal Judicial Center, and the U.S. Sentencing Commission, which will be submitted for the entire record.

I turn now to my colleague Senator Allard, if he would like to make an opening statement.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, thank you. I've enjoyed working with you in previous years, and I look forward to working with you this year.

I share your concern with—well, first of all, I want to thank you for holding this hearing, and thank the witnesses for coming and sharing their expertise with us. I appreciate the opportunity to discuss the Federal judiciary's fiscal year 2008 budget request and justification. And, as we consider the allocation of appropriated Federal dollars, it's important that we identify the needs and challenges facing our Federal judicial system.

GENERAL SERVICES ADMINISTRATION RENT

One issue that I've worked on for a considerable amount of time, and what I've supported, is legislation to address major problems affecting the Federal judiciary, specifically excessive rental charges by the General Services Administration (GSA) for courthouses and other space occupied by the courts across the country. I'm hearing from my judges in Colorado on that issue on a frequent basis. We must work together to prohibit the GSA from excessively overcharging to maintain and operate Federal court buildings and related costs.

Along with the chairman, I have some interest, also, in security issues. I have a question in that regard.

Thank you for being here. I look forward to the testimony.
Thank you, Mr. Chairman.
Senator DURBIN. Thank you, Senator Allard.
Judge Gibbons, the floor is yours.

OPENING STATEMENT OF JUDGE GIBBONS

Judge GIBBONS. Chairman Durbin, Senator Allard, as indicated, I'm Judge Julia Gibbons. I'm here to testify as chair of the Budget Committee of the Judicial Conference of the United States. Appearing with me today is Jim Duff, the new Director of the Administrative Office of the Courts. Jim brings much experience and knowledge of the judiciary to his position.

Mr. Chairman, you have been a great friend to the Federal judiciary through your work on the Judiciary Committee and the Appropriations Committee. I know that you were personally involved in efforts to provide $12 million in fiscal year 2006 supplemental funding to the United States Marshals Service for judicial security, part of which went for installation and monitoring of security systems in judges' homes. I speak for all judges when I say we greatly appreciate Congress' continued concern with the safety of judges and their families.

FISCAL YEAR 2007 FUNDING

On behalf of the third branch, I want to thank you, Mr. Chairman, Senator Brownback, and also Chairman Byrd, for making the judiciary a funding priority in the just completed fiscal year 2007 appropriations cycle. Although we were very concerned about the prospect of a hard freeze for the courts in 2007, Congress responded to those concerns and provided funding for the judiciary sufficient to maintain current onboard staffing levels in the courts, as well as to address some of our immigration and law enforcement workload needs. We are aware that many executive branch programs and agencies were funded at or below fiscal year 2006 levels, and we are very appreciative for the funding level we received. I assure you that we will use the resources you have given us wisely.

FISCAL YEAR 2008 REQUEST

The goal of our fiscal year 2008 request is to sustain the staffing gains you helped us achieve in 2007. After a decade of steady workload growth that was not matched with similar growth in staffing resources, the courts' workload has finally begun to stabilize. With the funding you provided for 2007, clerks and probation offices will be able to hire more than 200 staff to address critical workload needs and partially close the gap between workload and staffing.

We recently updated our 2008 budget request in order to more accurately reflect our funding needs in light of changed requirements due to financing assumptions and delayed enactment of our 2007 appropriations. Based on these changes, we have reduced the judiciary's 2008 appropriation requirements by $80 million.

Our revised 2008 appropriations requirements reflect an increase of $452 million over the 2007 enacted level. Of this amount, $390 million, or 86 percent, of the increase is for standard pay and nonpay inflationary adjustments and four adjustments to base, reflect-

ing increases in our space, information technology, defender services, and court security programs. The remaining $62 million of our request is for program enhancements for courthouse security, information technology improvements, and for an enhancement in our defender services program to increase the hourly rate paid to private panel attorneys representing indigent defendants in Federal criminal cases. This need for an increase in the amount we pay panel attorneys is discussed in detail in my written testimony, and you referred to it earlier Mr. Chairman. I look forward to answering any questions you may have about it.

In constructing the 2008 budget request, the judiciary made every effort to contain costs. In 2004, the Judicial Conference adopted a comprehensive strategy to reduce the rate of growth in the judiciary's appropriation requirements without hurting the administration of justice, and this strategy has produced results. Our rent validation initiative alone identified space rent overcharges by GSA that resulted in over $50 million in rent credits and cost avoidances. We are able to redirect these savings to other judiciary priorities, thus reducing our request for appropriated funds. Pursuing cost-containment initiatives throughout the judiciary is a top priority of the Judicial Conference.

FEDERAL PROTECTIVE SERVICE SECURITY

Finally, I turn to an issue of increasing concern to the judiciary; that is, the expense and quality of service provided the courts by the Federal Protective Service (FPS). FPS provides, on a reimbursable basis, exterior perimeter security for Federal agencies. We have received reports from several courts that perimeter security equipment provided by the FPS has not been maintained or repaired, thus compromising security in those courthouses. Last month Director Duff heard from a major metropolitan court which detailed inoperative FPS-provided exterior cameras and the absence of cameras at key locations, resulting in dead zones with no camera surveillance. Another district reported that, after pellets were fired at the courthouse at night, the court learned there was no surveillance footage to review, because FPS cameras were not recording any exterior views.

In many instances, the United States Marshals Service has assumed responsibility for repairing or replacing FPS-provided perimeter cameras. We appreciate the Marshals Service's proactive approach, but, unfortunately, it means that we are paying both the Marshals Service and FPS for identical services.

The situation with FPS has become sufficiently serious that last week the Judicial Conference endorsed a recommendation to support the efforts of the Marshals Service to assume security functions currently performed by FPS. We look forward to working with the subcommittee on this important issue.

PREPARED STATEMENTS

As I conclude my remarks, I ask that my entire statement, plus the statement of the Administrative Office and the other judicial entities to which you referred earlier, Mr. Chairman, be placed in the record. And, of course, I'll be happy to answer questions at the appropriate time.

Senator DURBIN. Without objection, the statements will be placed in the record.

[The statements follow:]

PREPARED STATEMENT OF HON. JULIA S. GIBBONS

INTRODUCTION

Chairman Durbin, Senator Brownback, and members of the subcommittee, I am Judge Julia Gibbons of the Sixth Circuit Court of Appeals. Our court sits in Cincinnati, Ohio, and my resident chambers are in Memphis, Tennessee. As the chair of the Judicial Conference Committee on the Budget, I come before you to testify on the Judiciary's appropriations requirements for fiscal year 2008, speaking on behalf of the 33,000 employees of the Judiciary judges, court staff, and chambers staff. I feel privileged to represent the Third Branch. In doing so, I will also apprise you of some of the challenges facing the Federal courts.

This is my third appearance before an appropriations subcommittee on behalf of the Federal Judiciary and, of course, my first appearance before this newly created Financial Services and General Government panel. We look forward to a productive relationship with the subcommittee and its staff as we begin the fiscal year 2008 budget cycle.

Mr. Chairman, you have been a great friend to the Federal Judiciary through your work on the Judiciary Committee and the Appropriations Committee. I know you were personally involved in efforts to provide $12 million in supplemental funding to the United States Marshals Service, part of which was for the installation and monitoring of security systems in judges' homes. I speak for all judges when I say we greatly appreciate Congress's continued concern with the safety of judges and their families.

ADMINISTRATIVE OFFICE DIRECTOR JAMES C. DUFF

Appearing with me today is James C. Duff, the new director of the Administrative Office of the United States Courts. He succeeds Leonidas Ralph Mecham who retired last year after a record 21 years leading the Administrative Office. Director Duff was appointed by the Chief Justice in April 2006 and took office in July 2006. Jim brings much experience and knowledge of the Judiciary to his position.

FISCAL YEAR 2007 FUNDING

Mr. Chairman and Senator Brownback, on behalf of the entire Judicial Branch I want to thank you and your colleagues, especially Chairman Byrd, for making the Judiciary a funding priority in the just completed fiscal year 2007 appropriations cycle. The fiscal year 2007 process was certainly atypical in concluding with a joint resolution providing full year funding for the nine unfinished appropriations bills. Although we were very concerned about the prospect of a hard freeze for the courts in fiscal year 2007, Congress responded to those concerns and provided funding for the Judiciary sufficient to maintain current on-board staffing levels in the courts as well as to address some of our immigration-related workload needs. We are aware that hundreds of Executive Branch programs were funded at or below fiscal year 2006 levels, and we are very appreciative for the funding level we received. I assure you that we will use these resources wisely.

While I will discuss the fiscal year 2008 budget request for the Judiciary later in my testimony, I would like to mention that, like some Federal agencies, we had to make certain assumptions about our fiscal year 2007 funding levels when we were finalizing our 2008 budget request several months ago. We assumed that Congress would provide the midpoint of the House-passed and Senate-reported appropriations bills from the 109th Congress, less 1 percent for a possible across-the-board rescission. The final enacted fiscal year 2007 appropriations level is $44 million below the fiscal year 2007 funding assumption we used to construct the fiscal year 2008 request. In order to provide you with our latest budget estimates, we recently updated the Judiciary's fiscal year 2008 request based on fiscal year 2007 enacted appropriations, other financing adjustments, and changes in requirements that have occurred since our 2008 budget was submitted. Our preliminary analysis indicates that the Judiciary's fiscal year 2008 appropriations requirements have declined by $80 million from the original request level. A chart identifying, by account, the revised appropriations request for fiscal year 2008 is provided at Appendix A. We will provide a complete budget re-estimate package to the subcommittee in May.

STATEMENTS FOR THE RECORD

Mr. Chairman, in addition to my statement and Director Duff's, I ask that the entire statements of the Federal Judicial Center, the Sentencing Commission, the Court of Appeals for the Federal Circuit, and the Court of International Trade be included in the hearing record.

ROLE OF THE FEDERAL JUDICIARY

Before I detail the specifics of our 2008 budget request, I will review various factors that shape the Federal Judiciary's budget. First and foremost is the role of the courts in our system of democratic government. Among our three independent, coequal branches of government, the Judiciary is the place where the people go to resolve their disputes peacefully and according to the rule of law. We are protectors of individual rights. Through trying those accused of crimes and sentencing those who are convicted, we also uphold societal values as expressed in the laws you pass. It may seem obvious, but it is worth noting that every item in our budget request relates to performing the functions entrusted to us under the Constitution. We have no optional programs; everything ultimately contributes to maintaining court operations and preserving the judicial system that is such a critical part of our democracy.

COST CONTAINMENT EFFORTS

The Judiciary is cognizant of the budget challenges facing our Nation and I want to assure the subcommittee that the Federal Judiciary is doing its part to contain costs. We are well aware that, with the conflicts in Iraq and Afghanistan and the investments being made to improve security here at home, non-security domestic spending has been flat for several years. And, looking forward, we know that the projected increase in mandatory entitlement spending in the coming years as baby boomers begin to retire will only add to Federal budget pressures. The Judiciary recognizes that the administration and Congress are rightfully concerned about overall Federal spending and budget deficits and that you face tough choices.

The Judicial Conference has always sought ways to reduce costs and enhance productivity. In fact, the Budget Committee which I currently chair has, since 1993, had an Economy Subcommittee whose sole purpose is to make funding recommendations to the full Budget Committee based on its independent analysis of the efficiency and effectiveness of Judiciary programs. The Economy Subcommittee is in effect the Third Branch's counterpart to the Office of Management and Budget. In fiscal year 2004 we retooled and enhanced our efforts to control costs. In that year, the Judiciary received a significant reduction to its budget request, primarily due to across-the-board cuts applied during final conference on our appropriations bill. This funding shortfall resulted in staff reductions of 1,350 employees, equal to 6 percent of the courts' on-board workforce. Of that number, 328 employees were fired, 358 employees accepted buyouts or early retirements, and 664 employees left through normal attrition and were not replaced.

The 2004 situation made clear that the Judicial Conference had to take steps to contain costs in a way that would protect the judicial process and ensure that budget cuts would not harm the administration of justice. In March 2004, the late Chief Justice William H. Rehnquist charged the Judicial Conference's Executive Committee with leading a review of the policies, practices, operating procedures, and customs that have the greatest impact on the Judiciary's costs, and with developing an integrated strategy for controlling costs. After a rigorous 6-month review by the Judicial Conference's various program committees, the Executive Committee prepared, and the Judicial Conference endorsed, a cost-containment strategy. The strategy focused on the primary cost drivers of the Judiciary's budget, which included an examination of the number of staff working in the courts, the amount they are paid, and the rent we pay to the General Services Administration for courthouses and leased office space. To be frank, cost containment is not the most popular initiative in all quarters of the Judiciary. But the courts realize it is necessary, and we have had great cooperation Judiciary-wide as we have moved forward on cost containment initiatives. Pursuing the implementation of cost containment initiatives will continue to be a top priority of the Judicial Conference.

Rent Validation Project

The amount of rent we pay to GSA has been a matter of concern to the Judiciary for more than 15 years. Our GSA rent bill consumes about 20 percent of the courts' operating budget, and we project the rent bill will exceed $1 billion in fiscal year 2008. Our relationship with GSA, though strained in recent years, has become more productive as Director Duff will discuss in more detail in his testimony. In addition,

we remain vigilant in our efforts to control our rent costs, and at present GSA and the Judiciary are working cooperatively to this end.

The Judiciary's rent validation project has achieved significant savings. This initiative originated in our New York courts where staff spent months scrutinizing GSA rent bills and found rent overcharges. The cumulative effect of this discovery was savings and cost avoidance over 3 fiscal years totaling $30 million. The Administrative Office expanded this effort nationwide by training all circuit executive offices to research and detect errors in GSA rent billings. Although it is quite time consuming, detailed reviews of GSA rent billings are now a standard business practice throughout the courts. Through the rent validation effort we recently identified additional overcharges totaling $22.5 million in savings and cost avoidance over 3 years. GSA has been very responsive to correcting billing errors that we bring to their attention. By identifying and correcting space rent overcharges we are able to re-direct these savings to other Judiciary requirements, thereby reducing our request for appropriated funds.

Rent Caps

To contain costs further, the Judiciary is establishing budget caps in selected program areas in the form of maximum percentage increases for annual program growth. For our space and facilities program, the Judicial Conference approved in September 2006 a cap of 4.9 percent on the average annual rate of growth for GSA rent requirements for fiscal years 2009 through 2016. By comparison, the increase in GSA rent in our fiscal year 2005 budget request was 6.6 percent. This cap will produce a GSA rent cost avoidance by limiting the annual amount of funding available for space rental costs, and courts will have to further prioritize space needs and deny some requests for additional space.

Other Cost Containment Initiatives

The Judiciary has adopted and is pursuing a number of measures to contain costs and improve efficiency throughout the Federal courts. These initiatives include redefining work requirements for probation officers, imposing tighter restrictions on appointing new magistrate judges, consolidating computer servers, and modifying courthouse space design standards. I would encourage members of the subcommittee to read a compendium of these initiatives in our report entitled Innovation in Lean Times: How Federal Court Operations Are Changing to Meet Demands. This report was prepared by the Administrative Office in July 2006 and distributed to the House and Senate Appropriations Subcommittees in the 109th Congress. I have asked Administrative Office staff to provide the report to the current appropriations subcommittees as well.

THE JUDICIARY'S ROLE IN HOMELAND SECURITY

The role of the Judiciary in the Nation's homeland security is often overlooked. Actions taken by the Department of Homeland Security and the Department of Justice have a direct and immediate impact on the Federal courts. Whether it is costly high-profile terrorist cases or soaring increases in immigration cases and related appeals, much of the workload ends up on Federal court dockets, and sufficient resources are required in order to respond to it. In recent years, Congress and the administration have significantly increased spending for homeland security through the annual and supplemental appropriations processes. Non-defense homeland security spending has more than tripled since 2001. In sharp contrast, appropriations for the courts' operating budget have increased only 33 percent and on-board court staffing levels have declined by 5 percent. Increased spending on homeland security is expected to continue, as evidenced by the President's Fiscal Year 2008 Budget, which includes a 9.5 percent increase in government-wide non-defense homeland security spending. The President's budget includes an unprecedented $13 billion to strengthen border security and immigration enforcement, a component of our workload in which we have seen dramatic growth in recent years. In fact, immigration-related cases now account for 25 percent of the district courts' criminal caseload, up from 18 percent in 2001, and surpass all other offense categories except drug cases. This President's request includes funding for 3,000 new border patrol agents to achieve the goal of doubling the force by the end of 2008 (18,000+ agents) from the 2001 level (9,100 agents). The Judiciary cannot absorb the additional workload generated by homeland security initiatives within current resource levels.

THE JUDICIARY'S WORKLOAD [1]

I turn to a discussion of the workload facing the courts. As indicated in the caseload table in our fiscal year 2008 budget request, 2007 caseload projections, which are utilized to compute fiscal year 2008 staffing estimates, increase slightly in probation and pretrial services, and decline slightly in appellate, civil, and criminal filings. There is a steep decline in projected bankruptcy filings. While our caseload has begun to stabilize after a decade of steady growth, it nonetheless remains at near-historic levels in most categories. I will discuss some recent trends and caseload drivers and try to offer some context for these workload figures.

Probation and Pretrial Services

Workload in our probation and pretrial services programs continues to grow. The number of people under the supervision of Federal probation officers hit a record 113,697 in 2006 and is expected to increase in 2007 to 114,600. In addition to the increased workload, the work of probation officers has become significantly more difficult. In 1985, fewer than half of the offenders under supervision had served time in prison. By 2006, the percentage had climbed to nearly 80 percent. As these figures indicate, probation officers no longer deal primarily with individuals sentenced to probation in lieu of prison. Offenders coming out of prison have greater financial, employment, and family problems than when they committed their crimes. In addition, offenders under supervision have more severe criminal histories than in the past. Between 1995 and 2005, there was a 78 percent increase in the number of offenders sentenced with more severe criminal backgrounds. Offenders re-entering the community after serving time in prison require close supervision by a probation officer to ensure they secure appropriate housing and employment. Successful re-entry improves the likelihood that offenders will pay fines and restitution and become taxpaying citizens.

Recent legislation will also increase our probation workload. The Adam Walsh Child Protection and Safety Act of 2006 is expected to increase significantly the number of sex offenders coming into the Federal probation and pretrial system for supervision. Monitoring the behavior of sex offenders is very challenging and requires intense supervision on the part of probation and pretrial services officers to protect the community.

Appellate Filings

Appellate filings hit an all-time high of 68,313 in 2006 and are expected to decline to 67,000 filings in 2007. The recent growth in the appellate docket has been due to more Board of Immigration Appeals (BIA) decisions from the Department of Justice (DOJ) being challenged in the appellate courts, particularly in the Second and Ninth Circuits. In fiscal year 2006, 33 percent (11,911) of all BIA decisions were appealed to the Federal courts, up from 6 percent (1,757) in fiscal year 2001. These BIA appeals often turn on a credibility determination by a DOJ immigration judge thus requiring close judicial review of a factual record by the appellate courts.

Along with the increase in BIA appeals, the courts have seen significant increases in criminal appeals resulting from the Supreme Court rulings in *United States* v. *Booker* and *United States* v. *Fanfan* in which the Court held judge-found sentencing factors unconstitutional in a mandatory sentencing scheme and made Federal sentencing guidelines advisory. Criminal appeals are currently 29 percent higher than they were prior to the decisions in those cases. The Supreme Court will decide two cases this term related to the appellate review of post-Booker sentences which may also impact the number of criminal appeals.

Civil Filings

Civil filings in the courts generally follow a more up and down filing pattern. In 2005 civil filings reached a record 282,758 filings followed by 244,343 filings in 2006 and 241,300 filings projected for 2007. The record filings in 2005 were largely due to the Homegold/Carolina Investors fraud case in North Carolina and a spike in personal injury liability lawsuits.

Criminal Filings

Criminal filings for 2007 are projected to total 67,200, down slightly from the 2006 level, but still within 5 percent of the all-time high set in 2004 of 71,098 filings. We understand that criminal filings may be depressed due to significant vacancies in Assistant U.S. Attorney positions nationwide. As these vacancies are filled, we expect criminal filings to increase again.

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[1] Unless otherwise stated, caseload figures reflect the 12-month period ending in June of the year cited (i.e., 2006 workload reflects the 12-month period from June 30, 2005 to June 30, 2006.

Although overall criminal caseload in the Federal courts has begun to level off, caseload in the five district courts along the southwest border with Mexico has soared since 2001 as a result of border and law enforcement initiatives undertaken by the Department of Homeland Security and Department of Justice. Those five districts out of a total 94 judicial districts account for nearly one-third of all criminal cases nationwide. Particularly hard hit is the District of New Mexico where criminal filings have nearly doubled since 2001 (up 92 percent) and the Southern District of Texas where filings are up 40 percent.

Bankruptcy Filings

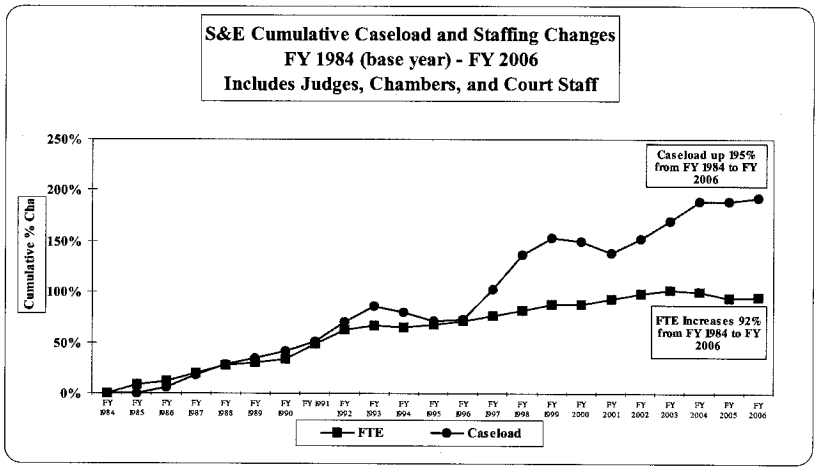
The sharp decline in bankruptcy filings projected for 2007 clearly reflects the impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) that went into effect October 17, 2005. The Administrative Office projects bankruptcy filings will decline by more than 500,000 filings from 2006 to 2007. Although filings have started to rebound, no consensus exists among bankruptcy experts as to when, or if, filings will return to pre-BAPCPA levels. Of course, the root causes of bankruptcy job loss, business failure, medical bills, credit problems, and divorce were not affected by the legislation and are expected to continue to be the primary drivers of filings. The number of filings alone, however, should not be viewed as the sole indicator of overall workload. BAPCPA created new docketing, noticing, and hearing requirements that make addressing the petitions more complex and time-consuming. Preliminary information from 10 courts now being studied suggests that the actual per-case work required by the bankruptcy courts has increased significantly under the new law, at least partially offsetting the impact on the bankruptcy courts of lower filings.

CASELOAD AND STAFFING: A HISTORICAL PERSPECTIVE

It is useful to examine Judiciary workload and staffing from a historical perspective. The chart below details Judiciary staffing and aggregate caseload for fiscal year 1984 through fiscal year 2006. Aggregate caseload is a composite of criminal, bankruptcy, appellate, and civil case filings as well as our probation and pretrial services programs. This chart illustrates several things. First, it shows the steady growth in the courts' caseload over the last 20 years. The chart also shows the cyclical nature of the courts' caseload when viewed in the aggregate: caseload peaks, declines slightly, then tends to peak again. Lastly, it shows that staffing resources have lagged well behind the increase in caseload for the last decade.

From fiscal year 1984 to fiscal year 2006, the courts' aggregate caseload increased by 195 percent while total court staffing which includes judges, chambers staff, and staff in our clerks and probation and pretrial services offices increased by only 92 percent. Staffing levels generally kept pace with caseload growth through the mid-1990's. But over the last decade caseload began to outpace court staffing levels and, to date, the courts have not had the resources needed to catch up. And the gap has widened in recent years. Between fiscal years 2001 and 2006 the courts' aggregate caseload increased by 23 percent while staffing resources increased by only 1 percent.

What has been the impact of this resource gap? The Judiciary has sought to narrow the gap through the implementation of automation and technology initiatives, improved business practices, and cost-containment efforts, but we have not been able to close it entirely. Our statistics indicate that the courts are struggling to meet workload demands. Pending cases carried over from 1 year to the next indicate a lack of judge and court staff resources. From fiscal year 1996 to 2006, the number of criminal cases pending per filing increased 55 percent, appeals cases pending per filing increased 13 percent, bankruptcy cases pending per filing increased 13 percent, and civil cases pending per filing increased 4 percent. If courts do not have the judges and staff needed to address workload adequately, civil cases are delayed as the district courts must focus on the criminal docket to meet provisions of the Speedy Trial Act, clerks offices must reduce office hours for the public in order to focus on case management activities, and probation officers have to reduce supervision for some offenders in order to focus on the more dangerous supervision cases. These are just a few examples.



The Judiciary uses regularly updated staffing formulas for determining the number of staff required in clerks and probation and pretrial services offices. Each formula incorporates multiple workload factors, but case filings are a primary determinant of the courts' staffing needs. Based on these staffing formulas, to be fully staffed we would need an additional 2,000 people in fiscal year 2008 above current on-board levels to address the courts' workload needs. Of course I am not suggesting that Congress provide the Judiciary with funding for such a dramatic increase in staff. But I am making the point that the courts are currently understaffed. With the resources Congress provided the Judiciary in fiscal year 2007, the courts are in a position to fill more than 200 new positions to address our most critical workload needs, particularly for immigration-related workload in the district and appellate courts. Because fiscal year 2007 funds were not made available to the courts until halfway into the fiscal year, all of these new staff may not be on-board until 2008. For this reason, and as a cost containment measure, our revised budget estimates for fiscal year 2008 no longer include funding for new positions in clerks and probation/pretrial offices. It is therefore critical that the courts be funded at a current services level in fiscal year 2008 in order to sustain the staffing gains funded in fiscal year 2007. The fact that the courts' caseload has stabilized after a decade of steady growth affords us the opportunity to begin closing the gap between our staffing levels and our workload. The funding provided in 2007 will enable the courts to begin to do so.

FEDERAL PROTECTIVE SERVICE

An issue of increasing concern to the Judiciary is the expense and quality of security provided the courts by the Federal Protective Service (FPS). FPS provides, on a reimbursable basis, exterior perimeter security for Federal agencies. FPS security charges are of two types: the mandatory "basic" security charge which is a fee assessed to each tenant agency based solely on the space occupied; and a "building-specific" security charge that is assessed against each tenant agency to pay for the acquisition, maintenance and repair of security equipment provided by FPS. Examples of building-specific security include the posting of FPS contract security guards at a facility and perimeter cameras that view the exterior areas of federal buildings. Both the basic and building specific charges are paid to FPS out of our Court Security appropriation. The Judiciary does not have control over the increases charged by FPS for the mandatory basic security charge. According to an FPS estimate, the Judiciary will incur a $4 million increase for basic security charges in fiscal year 2008 because FPS is increasing the rate by approximately 46 percent, from 39 cents to 57 cents per square foot.

We have received reports from several courts that perimeter security equipment provided by FPS has not been maintained or repaired, thus compromising security in those courthouses. A district judge, who is the chair of the court security committee at a major metropolitan courthouse, wrote Director Duff last month detailing his concerns regarding perimeter security deficiencies at his courthouse. He wrote

of inoperative FPS-provided exterior cameras and the absence of cameras at key locations resulting in "dead zones" with no camera surveillance. Another district court reported that after pellets were fired at the courthouse one night, the court learned there was no surveillance footage to review because FPS cameras were not recording any exterior views.

These and similar situations nationwide during fiscal year 2006 resulted in a number of courthouses with serious security vulnerabilities. In order to help ensure that the courts have adequate security, the United States Marshals Service (USMS) assumed responsibility for repairing or replacing FPS-provided perimeter cameras at a number of courthouses where it was apparent that FPS was not able to do so. This resulted in the Judiciary's paying for the same services twice: once to FPS in the building-specific security charge and also to the USMS in the funding we transfer to it for systems and equipment for interior and perimeter courthouse security.

FPS continues to be unable to provide the Judiciary with adequate cost-effective services, working equipment, detailed billings records, and timely cost projections. FPS has chronic financial management and billing problems evidenced by the $60 million funding shortfall it reported in November 2006 and which recent reports indicate has since grown to $80 million. In response to these shortcomings, the USMS has initiated a nationwide survey to assess the status of perimeter security at court facilities. The Judiciary greatly appreciates its proactive efforts in this area. Because of on-going FPS performance issues, the Judicial Conference last week endorsed a recommendation to support the efforts of the USMS, through legislative means if necessary, to assume security functions currently performed by FPS at court facilities (where the Judiciary is the primary tenant) and to receive the associated funding. The USMS has the expertise and provides excellent service with low administrative expenses. It takes responsibility for its work. FPS on the other hand has chronic funding problems that hamper its ability to maintain its security equipment adequately.

Ensuring the safety of judges, court employees, attorneys, jurors, defendants, litigants, and the public in court facilities is of paramount importance to the Judiciary. For this reason, we support expansion of the USMS's current mission to include the perimeter security of court facilities nationwide. We look forward to working with the subcommittee on this very important issue.

FISCAL YEAR 2008 BUDGET REQUEST

As I mentioned earlier in my testimony, we constructed our fiscal year 2008 budget request based on actions in the 109th Congress on fiscal year 2007 appropriations bills. Specifically, we assumed for each Judiciary account that Congress would provide the midpoint of the House-passed and Senate-reported appropriations bills from the 109th Congress, less 1 percent for a possible across-the-board rescission. The final enacted fiscal year 2007 appropriations level is $44 million below the fiscal year 2007 funding assumption we used to construct the fiscal year 2008 request. Over the last several weeks, Administrative Office staff have been working with the various Judicial Branch entities to update fiscal year 2008 funding requirements for each account based on enacted fiscal year 2007 appropriations as well as other financing adjustments and changes in requirements that have occurred since our 2008 budget was finalized. Our preliminary analysis indicates that the Judiciary's fiscal year 2008 appropriations requirements have declined by $80 million from the request level of $6.51 billion, resulting in a revised appropriation requirement of $6.43 billion. A summary table detailing the original and revised fiscal year 2008 appropriations request for each Judiciary account is included at Appendix A. The appropriations increase the Judiciary is seeking for fiscal year 2008, which I will describe briefly, is reflective of these revised requirements. As I mentioned earlier, we will provide a complete budget re-estimate package to the subcommittee in May.

As a result of our recent update of requirements, the Judiciary is requesting a 7.6 percent overall increase above fiscal year 2007 enacted appropriations. The courts' Salaries and Expenses account requires a 6.7 percent increase for fiscal year 2008. We believe this level of funding represents the minimum amount required to meet our constitutional and statutory responsibilities. While this may appear high in relation to the overall budget request submitted by the administration, I would note that the Judiciary does not have the flexibility to eliminate or cut programs to achieve budget savings as the Executive Branch does. The Judiciary's funding requirements essentially reflect basic operating costs which are predominantly for personnel and space requirements. Eighty-six percent ($390 million) of the $452 million increase being requested for fiscal year 2008 funds the following base adjustments, which represent items for which little to no flexibility exists:

—Standard pay and benefit increases for judges and staff. This does not pay for any new judges or staff but rather covers the annual pay adjustment and benefit increases (e.g. COLAs, health benefits, etc.) for currently funded Judiciary employees. The amount budgeted for the cost-of-living adjustment is 3.0 percent for 2008.
—An increase in the number of on-board active and senior Article III judges and the annualization of new magistrate judge positions.
—The projected loss in non-appropriated sources of funding. In addition to appropriations, the Judiciary collects fees that can be used to offset appropriation needs. Fee collections not utilized during the year may be carried over to the next fiscal year to offset appropriations requirements. We will keep the subcommittee apprised of changes to fee or carryforward projections as we move through fiscal year 2007.
—Space rental increases, including inflationary adjustments and new space delivery, court security costs associated with new space, and an increase for Federal Protective Service charges for court facilities.
—Adjustments required to support, maintain, and continue the development of the Judiciary's information technology program, which has allowed the courts to "do more with less" absorbing workload increases while downsizing staff. Mandatory increases in contributions to the Judiciary trust funds that finance benefit payments to retired bankruptcy, magistrate, and Court of Federal Claims judges, and spouses and dependent children of deceased judicial officers. Inflationary increases for non-salary operating costs such as supplies, travel, and contracts.
—Costs associated with Criminal Justice Act (CJA) representations. The Sixth Amendment to the Constitution guarantees that all criminal defendants have the right to the effective assistance of counsel. The CJA provides that the Federal courts shall appoint counsel for those persons who are financially unable to pay for their defense. The number of CJA representations is expected to increase by 8,200 in fiscal year 2008, as the number of defendants for whom appointed counsel is required increases.

After funding these adjustments to base, the remaining $62 million requested is for program enhancements. Of this amount:

—$22 million to increase the non-capital panel attorney rate from $96 to $113 per hour. I will discuss this requested increase in more detail in a moment. $11 million would provide for critical security-related requirements.
—$10 million will provide for investments in new information technology projects and upgrades, and courtroom technology improvements.
—$11 million will provide for unfunded fiscal year 2007 recurring court operating expenses that were not funded in fiscal year 2007 but are necessary requirements in fiscal year 2008.
—Of the remaining $8 million, $1 million would provide for two additional magistrate judges and associated staff; $1 million will pay for the Supreme Court's exterior landscape renovation project; $2 million is needed for staffing increases for the Supreme Court (+7 FTE), Federal Circuit (+6 FTE), and the Federal Judicial Center (+7 FTE). The remaining $4 million is for smaller requirements in other Judiciary accounts.

INCREASE IN NON-CAPITAL PANEL ATTORNEY RATE

We believe that one program enhancement in our budget request deserves strong consideration in order to ensure effective representation for criminal defendants who cannot afford to retain their own counsel. We are requesting $22 million to increase the non-capital panel attorney rate to $113 per hour effective January 2008. A panel attorney is a private attorney who serves on a panel of attorneys maintained by the district or appellate court and is assigned by the court to represent financially-eligible defendants in Federal court. These attorneys are currently compensated at an hourly rate of $92 for non-capital cases and up to $163 for capital cases. The hourly non-capital rate will increase to $94 per hour effective April 1, 2007 as a result of the $2 per hour cost-of-living adjustment you provided in fiscal year 2007. We are very grateful for this modest rate adjustment. The Judiciary requests annual cost-of-living adjustments for panel attorneys similar to the annual adjustments provided to federal employees for two reasons. First, cost-of-living adjustments allow the compensation paid to panel attorneys to keep pace with inflation to maintain purchasing power and, in turn, enable the courts to attract and retain qualified attorneys to serve on their CJA panels. Second, regular annual adjustments eliminate the need to request large "catch-up" increases in order to account for several years with no rate adjustments. The subcommittee recognized the importance of annual

cost-of-living adjustments by providing one to panel attorneys in fiscal year 2007. I would note that the previous subcommittee provided a cost-of-living adjustment in fiscal year 2006.

Our request to increase the non-capital hourly rate to $113 amounts to a partial catch-up increase. The non-capital rate was increased to $90 in May 2002 but no adjustments were made to that rate until January 2006, when it was raised to $92, and which will increase to $94 in a few weeks, on April 1, as I just mentioned. In comparison, since May 2002, the Department of Justice has been paying $200 per hour to retain private attorneys with at least 5 years of experience to represent current or former federal employees in civil, congressional, or criminal proceedings. The Judiciary requested a panel attorney rate of $113 per hour in fiscal years 2002, 2003, and 2004. In report language accompanying the fiscal year 2004 appropriations bill, the subcommittee with jurisdiction over our funding at the time said the Judiciary was not presenting a strong case for the $113 rate and suggested we survey the courts and gather data to make a more compelling case. Thus, we did not request the $113 rate in fiscal years 2005 and 2006 while the Administrative Office conducted surveys of judges and panel attorneys and analyzed the responses.

In a 2004 survey of Federal judges, over half of them indicated that their courts were currently experiencing difficulty identifying enough qualified and experienced panel attorneys to accept appointments in non-capital cases. In the first statistically valid, nationwide survey of individual CJA panel attorneys conducted in March 2005, a significant percentage (38 percent) of the over 600 attorneys surveyed reported that since the hourly compensation rate had increased to $90 per hour in May 2002, they had nevertheless declined to accept a non-capital CJA appointment. Strikingly, after covering overhead costs for the predominantly solo and small-firm lawyers who take CJA cases, their net pre-tax income for non-capital CJA representations amounted to only about $26 per compensated hour. A large proportion (70 percent) of the CJA attorneys surveyed in March 2005 reported that an increase to the $90 hourly rate is needed for them to accept more non-capital cases.[2]

The requested increase to $113 per hour reflects the minimum amount the Judicial Conference believes is needed to attract qualified panel attorneys to provide the legal representation guaranteed by the Sixth Amendment. Indeed, $113 is the level that the Judiciary was seeking in 2002 when Congress increased the rate to $90. Recognizing fiscal realities, the $113 rate request is well below the $133 rate authorized by the CJA. I urge you to give this rate increase strong consideration.

CONTRIBUTIONS OF THE ADMINISTRATIVE OFFICE

Year in and year out, the Administrative Office (AO) of the United States Courts serves and provides critical support to the courts. The more the courts have to do, and the fewer resources with which they have to do it, the more challenging the job of the AO becomes. With only a fraction (1.6 percent) of the resources that the courts have, the AO does a superb job of supporting our needs.

The AO has key responsibilities for Judicial administration, policy implementation, program management, and oversight. It performs important administrative functions, but also provides a broad range of legal, financial, program management, and information technology services to the courts. None of these responsibilities has gone away and new ones are continually added, yet the AO staffing level has been essentially frozen for 10 years.

The AO played a central role in assisting the courts to implement the bankruptcy reform legislation, as well as in helping those courts affected by Hurricanes Katrina and Rita and the myriad of space, travel, technology, and personnel issues that had to be addressed.

In my role as Chair of the Judicial Conference Committee on the Budget, I have the opportunity to work with many staff throughout the AO. They are dedicated, hard working, and care deeply about their role in supporting this country's system of justice.

The fiscal year 2008 budget request for the Administrative Office is $78.5 million, representing an increase of $6.2 million. All of the requested increase is necessary to support adjustments to base, mainly standard pay and general inflationary increases, as well as funding to replace the anticipated lower level of fee revenue and carryover amounts with appropriated funds in fiscal year 2008.

I urge the subcommittee to fund fully the Administrative Office's budget request. The increase in funding will ensure that the Administrative Office continues to provide program leadership and administrative support to the courts, and lead the ef-

[2] Although rates have been raised to $92 per hour since the survey was taken, this $2 per hour increase would not have materially affected the survey responses.

forts for them to operate more efficiently. Director Duff discusses the AO's role and budget request in more detail in his testimony.

CONTRIBUTIONS OF THE FEDERAL JUDICIAL CENTER

I also urge the subcommittee to approve full funding for the Federal Judicial Center's request of $24.5 million for fiscal year 2008.

The Center's director, Judge Barbara Rothstein, has laid out in greater detail the Center's needs in her written statement. I simply add that the Center plays a vital role in providing research and education to the courts. The Judicial Conference and its committees request and regularly rely on research projects by the Center. These provide solid empirical information on which judges, the Judiciary, and Congress and the public, depend on in reaching important decisions relating to litigation and court operations. Likewise, the Center's educational programs for judges and court staff are vital in preparing new judges and court employees to do their jobs and in keeping them current so that they can better deal with changes in the law, and in tools like technology that courts rely on to do their work efficiently.

The Center has made good use of its limited budget. It has made effective use of emerging technologies to deliver information and education to more people more quickly. The relatively small investment you make in the Center each year (less than one-half of one percent of the Judiciary's budget) pays big dividends in terms of the effective, efficient fulfillment of the courts' mission.

CONCLUSION

Mr. Chairman, I hope that my testimony today provides you with a better appreciation of the challenges facing the Federal courts. I realize that fiscal year 2008 is going to be another tight budget year as increased mandatory and security-related spending will result in further constrained domestic discretionary spending. The budget request before you recognizes the fiscal constraints you are facing. Through our cost-containment efforts we have significantly reduced the Judiciary's appropriations requirements without adversely impacting the administration of justice. I know that you agree that a strong, independent Judiciary is critical to our Nation. I urge you to fund this request fully in order to enable us to maintain the high standards of the United States Judiciary. A funding shortfall for the Federal courts could result in a significant loss of existing staff, dramatic cutbacks in the levels of services provided, and a diminution in the administration of justice.

Thank you for your continued support of the Federal Judiciary. I would be happy to answer any questions the subcommittee may have.

APPENDIX A.—JUDICIARY APPROPRIATION FUNDING

[Dollars in thousands]

Appropriation Account	Fiscal Year 2007			Fiscal Year 2008			
	Assumed Appropriation [1] (Oct. 15, 2006)	Enacted Level Public Law 110–5 [2] (Feb. 15, 2007)	Change: Enacted vs. Assumed	President's Budget (Feb. 5, 2007)	Revised Budget Estimates (March 21, 2007)	Change: Revised Estimates vs. President Budget	Percent Change: Fiscal Year 2008 Revised vs. Fiscal Year 2007 Enacted
U.S. Supreme Court:							
Salaries and Expenses	$62,792	$62,576	($216)	$66,526	$66,526	.....	$6.3
Care of Building and Grounds	12,829	11,427	(1,402)	12,201	12,201	.....	6.8
Total	75,621	74,003	(1,618)	78,727	78,727	.....	6.4
U. S. Court of Appeals for the Federal Circuit	25,407	25,311	(96)	28,538	28,442	($96)	12.4
U.S. Court of International Trade	16,037	15,825	(212)	16,727	16,632	(95)	5.1
Courts of Appeals, District Courts and Other Judicial Services:							
Salaries and Expenses:							
Direct	4,527,194	4,476,550	(50,644)	4,854,455	4,774,757	(79,698)	6.7
Vaccine Injury Trust Fund	3,971	3,971	.....	4,099	4,099	.....	3.2
Total	4,531,165	4,480,521	(50,644)	4,858,554	4,778,856	(79,698)	6.7
Defender Services	747,987	776,283	28,296	859,834	859,834	.....	10.8
Fees of Jurors and Commissioners	62,448	60,945	(1,503)	62,350	63,081	731	3.5
Court Security	395,045	378,663	(16,382)	421,789	421,789	.....	11.4
Subtotal	5,736,645	5,696,412	(40,233)	6,202,527	6,123,560	(78,967)	7.5
Administrative Office of the U.S. Courts	73,326	72,377	(949)	78,536	7	8,536	08.5
Federal Judicial Center	23,211	22,874	(337)	24,835	24,475	(360)	7.0
Judiciary Retirement Funds	58,300	58,300	.....	65,400	65,400	.....	12.2
U.S. Sentencing Commission	15,266	14,601	(665)	16,191	15,477	(714)	6.0
Direct	6,019,842	5,975,732	(44,110)	6,507,382	6,427,150	(80,232)	.....
Vaccine Injury Trust Fund	3,971	3,971	.....	4,099	4,099	.....	.....

APPENDIX A.—JUDICIARY APPROPRIATION FUNDING—Continued

[Dollars in thousands]

Appropriation Account	Fiscal Year 2007			Fiscal Year 2008			
	Assumed Appropriation [1] (Oct. 15, 2006)	Enacted Level Public Law 110–5 [2] (Feb. 15, 2007)	Change: Enacted vs. Assumed	President's Budget (Feb. 5, 2007)	Revised Budget Estimates (March 21, 2007)	Change: Revised Estimates vs. President Budget	Percent Change: Fiscal Year 2008 Revised vs. Fiscal Year 2007 Enacted
Total	6,023,813	5,979,703	(44,110)	6,511,481	6,431,249	(80,232)	7.6

[1] Reflects the assumed fiscal year 2007 appropriation level that was used in developing the fiscal year 2008 President's Budget. It was based on the House/Senate midpoint less 1 percent for an assumed across-the-board rescission.
[2] The bottom line total is consistent with the fiscal year 2007 amount appropriated to the Judiciary in H.J. Res. 20 (Public Law 110–5).

PREPARED STATEMENT OF PAUL R. MICHEL, CHIEF JUDGE, UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

Mr. Chairman, thank you for allowing me to submit my statement supporting the United States Court of Appeals for the Federal Circuit's fiscal year 2008 budget request.

Our request totals $28,442,000, an increase of $3,131,000 (12 percent) over the fiscal year 2007 appropriation of $25,311,000.

Fifty-six percent of that increase, $1,761,000, is for congressionally- and contractually-mandated adjustments to base (such as COLAs and escalation in rent and contracts), as well as one adjustment to the base appropriation for lease of judges' workspace.

This lease increase, a request for $496,000, will allow us to provide the work space necessary for four judges (and their staff) now eligible to take senior status and an additional three judges who become eligible to take senior status in fiscal year 2009. Even now our courthouse simply does not have space for the judge who took senior status during the past year, much less offer chambers to seven other judges eligible to take senior status in this fiscal year and the next.

The retention of judges through senior status is what has allowed this court to remain current. Since this court's inception in 1982, the number of active judges on our court has remained the same, even though our caseload has nearly doubled and the technology of our patent caseload has become increasingly complex. Clearly, the provision of adequate work space for judges willing to take senior status (as opposed to leaving the court through retirement) is critical to our being able to retain these highly valuable contributors to our court's output. If adequate work space cannot be provided, it is likely that some judges may simply retire, or remain active resulting in a very significant loss of judicial capacity.

Funding for off-site leased space was not provided in our fiscal year 2007 appropriation even though requested. Nevertheless the Administrative Office of the United States Courts (AO) has authorized GSA to seek suitable off-site space and negotiate a lease for senior judges, in accordance with Judicial Conference policy. The search is on-going. We are told, and know from past experience, that securing a lease and preparing chambers will take 6 to 12 months, making it necessary for us to have the funding available in fiscal year 2008.

Forty-four percent, $1,370,000, of the requested increase over the fiscal year 2007 approved appropriation is to fund programmatic increases for: (1) additional law clerk positions; (2) upgrades to six of the court's automated systems; and (3) two-way video and audio transmission capability between the court and remote sites around the country.

Additional Law Clerk.—$732,000 of the amount requested covers the cost of hiring an additional law clerk for each of the court's active judges for 6 months of fiscal year 2008. The increased workload now requires funding a fourth law clerk. The court presently has funding for only three law clerks for each judge and one secretary. This added funding would provide a fourth law clerk or assistant for each active judge. Indeed, Article III judges serving in the other 12 circuits of the Federal Judiciary have had funding for a fourth law clerk for years.

The Federal Circuit did not previously need parity, but I now ask for this funding for new positions because they are necessary in order to keep up with the sharp increase in the number of appeals filed. After years of steady increases in filings, case filings in fiscal year 2006 alone increased by 14 percent from fiscal year 2005. In addition, we face a sharp rise in the complexity of cases, many involving advanced and emerging technologies of great economic importance for American businesses.

Upgrade to Automated Systems.—$388,000 of the amount requested under program increases is necessary to provide new and improved electronic information technology services to the court, namely (a) improved automated case tracking and management; (b) automated e-filing of briefs by attorneys; (c) e-voting and commenting by judges; (d) automated conflict screening; (e) improved public Web site with posting of all briefs and opinions; and (f) off-site continuity of operations set-up, configuration and support for a back-up computer system at the administrative office site in Missouri.

The court is developing an improved electronic case tracking system, as well as electronic filing, voting, and conflict screening systems. All of these systems are recommended or required by the Judicial Conference. Their development requires hiring contractors, purchasing new equipment, and training court information technology staff. These new systems provide better, more accessible, and faster services for litigating lawyers, judges and judges' staffs, as well as making available to judges and court staff a more efficient method for tracking cases. The automated

conflict screening system reduces the risk of judges inadvertently participating in cases despite a financial conflict, and thus assists in assuring compliance with ethics requirements. It also is required by Judicial Conference policy. The Web site is our primary contact system with attorneys, academics, and the interested public.

Funding is included in this amount for off-site back-up computer equipment necessary to support the continuing operations of the court if a disaster disables our courthouse in Washington, D.C., which is located very near to the White House—a primary target for terrorists.

Remote Video Conferencing.—The remaining $250,000 of the requested amount covers the cost to provide remote video conferencing in one of our three courtrooms, in accordance with Judicial Conference and administrative office policy on funding such capability. Recently, the Judiciary adopted information technology initiatives for reducing the reliance on paper, achieving economy in its business processes, and providing better service to citizens at locations around the country. These initiatives are especially critical to our court because with our nationwide jurisdiction, our lawyers and their clients are scattered all across the country. The request is based on recommendations from the Judicial Conference and the Administrative Office of the United States Courts to provide two-way video and audio transmission between courtrooms and remote sites. With this beneficial technology attorneys can present oral arguments from anywhere in the country and avoid the cost in time and money of traveling to Washington, D.C., and staying here overnight. In addition, the court and citizens benefit greatly from hearing oral arguments which might otherwise not be presented to the court.

I would be pleased, Mr. Chairman, to answer any questions the committee may have or to meet with the committee members or staff about our budget request.

Thank you.

PREPARED STATEMENT OF JANE A. RESTANI, CHIEF JUDGE, UNITED STATES COURT OF INTERNATIONAL TRADE

Mr. Chairman, members of the committee: I would like to again thank you for providing me the opportunity to submit this statement on behalf of the United States Court of International Trade, a court established under Article III of the Constitution with exclusive nationwide jurisdiction over civil actions pertaining to matters arising out of the administration and enforcement of the customs and international trade laws of the United States.

The Court's fiscal year 2008 original budget request of $16,727,000 represented an overall increase of $690,000 or 4.3 percent over the fiscal year 2007 assumed appropriation of $16,037,000. This assumed appropriation included an across the board cut of 1 percent. In February, the Court received an appropriation of $15,825,000. Based on this enacted appropriation, and after a detailed and careful review, the Court's fiscal year 2008 budget request has been reduced to $16,632,000. This represents an overall increase of 5.1 percent over the enacted fiscal year 2007 appropriation. Despite the reduction, we anticipate that this request will enable the Court to maintain current services and provide for mandatory increases in pay, benefits and other inflationary adjustments to base, including increases in costs paid to GSA for rent and to the Federal Protective Service for building basic and building-specific security surcharges. These security surcharges provide for the Court's pro-rata share of installing, operating and maintaining systems for the critical and necessary security of the Federal Complex in lower Manhattan.

As it has done in the past, the Court continues to budget and expend funds in a conservative and cost effective manner, and will continue to do so to manage within the reduced request. Through the use of its annual appropriation and the Judiciary Information Technology Fund (JITF), the Court continues to promote and implement the objectives set forth in its long range plan for providing access to the Court through the effective and efficient delivery of information to litigants, bar, public, judges and staff. This access is of particular importance in realizing the Court's mission to resolve disputes by: Providing cost effective, courteous and timely service by those affected by the judicial process; providing independent, consistent, fair and impartial interpretation and application of the customs and international trade laws; and fostering improvements in customs and international trade law and practice and improvements in the administration of justice.

The Court continues to make substantial progress in implementing its information technology and cyclical maintenance programs. In fiscal year 2006, the Court: Purchased a new server for a public access terminal that will allow access to the Court's customized version of the Federal Judiciary's Case Management/Electronic Case Files (CM/ECF) System; purchased an additional server for storing utility files

and desktop images; purchased a high speed digital networked copier with scanning and faxing capabilities; cyclically upgraded laptops and purchased desktop computers, monitors and printers for a new judge; upgraded vital existing software applications, continued maintenance agreements for computer hardware and software applications; implemented the on-line system (pay.gov) for the payment of filing fees and the electronic application of CM/ECF for filing appeals and opening cases; upgraded to a new version of CM/ECF; and provided training in the new electronic case opening and filing of appeals applications to attorneys, staff and the public. Additionally, in fiscal year 2006, the Court continued its cyclical maintenance program by refurbishing chambers for a new judge, and offices for a new clerk of court, replacing aging furniture/chairs and upgrading public access corridors.

In fiscal year 2007, the Court has planned to: Purchase new courtroom and conference room technology systems, including an upgraded video conferencing system; replace the Court's Internet server and the server for the Court's library on-line cataloguing and acquisition system; replace desktop computer systems, laptops and printers in accordance with the Judiciary's cyclical replacement program; upgrade and support existing software applications; purchase new software applications to ensure the continued operational efficiency of the Court; support Court equipment by the purchase of yearly maintenance agreements; and upgrade copier machines in chambers and clerks' offices. The Court also will expand its developmental and educational programs for staff in the areas of job-related skills and technology.

In fiscal year 2008, the Court remains committed to using its carryforward balances in the Judiciary Information Technology Fund to continue its information technology initiatives and to support the Court's short-term and long-term information technology needs.

Additionally, the Court will continue its commitment to its cyclical replacement and maintenance program for equipment and furniture and for the courthouse. This program not only ensures the integrity of equipment and furnishings, but maximizes the use and functionality of the internal space of the courthouse. Moreover, the fiscal year 2008 request includes funds for the support and maintenance of the security systems upgraded by the Court in fiscal years 1999 through 2005, and the Court's COOP. Lastly, the Court will continue its efforts to address the educational needs of the bar and Court staff.

As I have stated in previous years, the Court remains committed to maintaining its security systems to ensure the protection of those who work in and visit the courthouse. In July, 2005, GSA received Senate approval for fiscal year 2006 funding for the design and construction of a security pavilion for entry into the building. In fiscal year 2006, the Court worked closely with GSA in the design and construction of this entrance pavilion. To that end, the Court, in fiscal year 2006, entered into a Reimburseable Work Authorization with GSA for a non-prospectus security project for the purchase and installation of additional security equipment, including cameras and for the upgrade of the Court's security infrastructure. The design phase was completed in fiscal year 2006 and construction began in fiscal year 2007. The Court will continue in fiscal year 2008 to work in full partnership with GSA during the last phases of construction in order to ensure the total success of this project. GSA projects a completion date in fiscal year 2008.

I would like to again emphasize that the Court remains committed to an approach of conservatively managing its financial resources through sound fiscal, procurement and personnel practices. As a matter of internal operating principles, the Court routinely engages in cost containment strategies in keeping with the overall administrative policies and practices of the Judicial Conference, particularly regarding rent, security costs, equipment costs, technology, contractual obligations and personnel. I can assure you that this management approach with respect to the Court's financial affairs is on-going.

Lastly, I would like to personally extend my deepest thanks and appreciation to Congress for recognizing the needs of the courts by providing, in fiscal year 2007, adequate funding to maintain current services so that the courts can remain committed to the administration of justice for all.

The Court's "General Statement and Information" and "Justification of Changes," which provide more detailed descriptions of each line item adjustment, were submitted previously. If the committee requires any additional information, we will be pleased to submit it.

PREPARED STATEMENT OF BARBARA J. ROTHSTEIN, DIRECTOR, FEDERAL JUDICIAL CENTER

INTRODUCTION

Mr. Chairman and members of the subcommittee: My name is Barbara J. Rothstein. I have been a U.S. district judge since 1980 and Director of the Federal Judicial Center since September 2003. The Center is the Federal courts' agency whose statutory mandate is to provide continuing education of judges, education of court employees, and research and analysis of Federal judicial processes and procedures.

I appreciate the opportunity to provide you this statement in support of our 2008 appropriations request. Because the Center, like the other judiciary accounts, is new to the subcommittee. I am taking this opportunity to provide a detailed description of our work.

I must stress at the outset that while the Center continues to perform its basic statutory duties, the combination of budget shortfalls and the staff reductions which the shortfalls have necessitated is colliding with an increase in new requirements. In recent years we have been asked by the Judicial Conference to undertake several large research projects, most of which have been to enable the Conference to respond to proposals and inquiries from Congress. For example, in response to a congressional request that the Federal judiciary "document how often courtrooms are actually in use," we are conducting a national study of how courtrooms are scheduled and actually used by Federal district and magistrate judges. In response to recent congressional proposals to streamline the processing of habeas corpus appeals of State capital convictions, the Center was asked by six committees of the Judicial Conference to conduct an extensive empirical study of all State prisoner capital habeas corpus petitions pending in the Federal courts. We are also in the midst of a multi-year study of the impact of the Class Action Fairness Act of 2005 (CAFA) on the resources of the Federal courts. The Center was asked to conduct this study by the Advisory Committee on Civil Rules as it considers whether rules changes may be needed in response to CAFA. In education, last year we were asked to provide enhanced training for judges and staff on new ethics-related guidance and on immigration cases in the circuit courts of appeals. Along with all of these tasks is the need to provide continuing education and study in connection with the changes brought about by the passage of a new bankruptcy statute.

Our ability to meet specific requests like these and, at the same time, continue our regular education and research programs will be jeopardized without at least a small increase in our staff.

2008 REQUEST

Our 2008 request is for $24,475,000, a 7 percent increase: $1,066,000 for standard adjustments to base to cover increases in compensation and benefits and inflationary increases in operating costs, and $535,000 for additional staff (7 FTE) to support the services the Center provides to the Judicial Branch.

The Center's Board, which the Chief Justice chairs, considered our proposed request at its November 2006 meeting and approved it for submission to Congress. I am confident that you will find it responsible and well grounded.

Our 2008 request seeks what is essentially a "current services" budget. The Center has been struggling with having received only one full current services increase since the early 1990s. Over these years, to compensate for appropriations that did not provide full adjustments to base, we reduced our staff 20 percent from 158 to 125. Even as our staff declined, the courts' need for our services has continued to grow. For this reason we are requesting funds to restore 10 (7 FTE) of the most critically needed of the 23 positions we have lost since 2003. Our budget submission provides greater detail on why these positions are needed and the services they will help provide.

The Center is proud of its work to promote improved judicial administration in the courts of the United States, even as its resources have declined. To make the most of our limited resources, we have made great use of educational technologies that reduce the need for travel, and we have carried out rigorous cost controls, internal staff and operational adjustments and reallocations, and personnel cuts. We have reached the point where such measures are no longer viable without impacting the quality of the services we provide. I respectfully urge you to find a way to provide the Center with the modest 7 percent increase it needs in 2008 to continue to provide the educational and analytical services for which judges and their staffs look to the Center.

ABOUT THE FEDERAL JUDICIAL CENTER

Below I highlight Center activities in 2006, focusing primarily on our education for Federal judges and the staffs of the courts and our research on court and case management. Much of this work involves coordination, cooperation, and consultation with committees of the Judicial Conference of the United States, with the Administrative Office, and with the U.S. Sentencing Commission.

The Center provides orientation programs on substantive legal issues, ethics, and trial and case-management techniques to groups of newly appointed judges.

The Center provides timely information and continuing instruction to help Federal judges and court staff comply with new legislation, Judicial Conference policies, and Supreme Court decisions. We also help courts apply effective leadership and management principles and engage in strategic planning for their near-term and future needs. Examples in this report include expanded ethics training for judges and staff, resources and programs on effective case management, an annual review of cases decided by the Supreme Court, programs for court units on strategic workforce planning, and a courtroom use study, conducted at the behest of the Judicial Conference in response to a congressional request that the Federal judiciary "document how often courtrooms are actually in use."

EDUCATION AND TRAINING

More than 2,000 Federal judge participants, 10,000 court staff participants, 40 circuit mediators, and 1,100 Federal defenders and their staff attended Center educational programs in 2006. Those programs included orientation and continuing education programs delivered by a variety of methods. Programs for judges, circuit mediators, Federal defenders, and court unit executives are traditionally in-person presentations, affording interaction on court-management and case-management issues, as well as on substantive and procedural matters. Court staff programs, designed for larger audiences, are typically not travel-based and include audio, video, and online conferences, as well as local training programs that are taught in the court units by Center-trained court staff or individuals with training experience using Center curriculum materials. We provided additional education through satellite broadcasts, streaming audio and video programs, web-based training programs, monographs and manuals, and videocassettes and audiocassettes. Advisory committees of court of appeals, district, magistrate, and bankruptcy judges, as well as court unit executives and staff, help in planning and producing Center education programs and publications.

EDUCATION PROGRAMS AND MATERIALS FOR JUDGES AND FOR LEGAL STAFF

SEMINARS AND WORKSHOPS FOR JUDGES, JANUARY 1-DECEMBER 31, 2006

	Number of Programs	Number of Participants
Orientations for newly appointed district judges	3	31
Orientations for newly appointed bankruptcy judges	3	73
Orientations for newly appointed magistrate judges	3	54
Conference for chief district judges	1	94
Conference for chief bankruptcy judges	1	69
Workshops for district and circuit judges	2	90
National workshops for district judges	3	377
National workshops for bankruptcy judges	2	262
National workshops for magistrate judges	2	368
National sentencing policy institute	1	72
Special-focus workshops	17	416
In-court seminars	15	199
TOTAL	53	2,105

The Center also held six programs for 1,107 Federal defenders and staff and one program for 43 circuit mediators.

Continuing education programs in 2006 included these national workshops:

—Three for district judges on judicial ethics and the Code of Conduct for U.S. Judges, recent developments in Federal jurisdiction, a review of pertinent decisions from the 2005–2006 Supreme Court term, prosecution of terrorists in Federal courts, 42 U.S.C. § 1983 qualified immunity, management and trial of patent cases, information technology for judges, sentencing post-*Booker*, complex

criminal case management, the science of drug addiction, an update on the Federal Rules of Evidence, and an update on employment discrimination law;
—two for bankruptcy judges that discussed the Code of Conduct; model rules and practice under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), judicial security, issues involving U.S. trustees under the new BAPCPA, judicial independence and accountability, recent developments in Chapter 7, 11, and 13 cases, U.S. Judicial Conference privacy policy, the dynamics of small business Chapter 11, Chapter 15 issues;
—two for magistrate judges on judicial ethics and the Code of Conduct, electronic discovery, legal and management issues in patent cases, media and the law, IT issues, cell site information and electronic surveillance law, electronic filing, privacy and protective orders, the science of drug addiction, and updates on the Federal Rules of Evidence, habeas corpus issues, Social Security law issues, and 42 U.S.C. § 1983 case law.

Seminars for small groups of judges on particular topics covered case management, intellectual property, international law and litigation, employment law, emerging issues in neuroscience, law and terrorism, advanced mediation strategy, law and genetics, managing capital construction projects, environmental law, immigration law, law and society, and law and science. We conduct many of these programs in collaboration with law schools or other educational institutions, which helps us leverage our funds.

Our conferences for chief district judges and chief bankruptcy judges focused on the roles and responsibilities of the chief judge in financial management and strategic resource planning, judicial security, the courtroom usage study, public attitudes towards the courts, and a program for new chief judges. We conducted both conferences in cooperation with the Administrative Office.

Programs for defender personnel included a national seminar and an appellate writing workshop for Federal defenders, a seminar for Federal defender investigators and paralegals, and a law and technology workshop for Federal defender staff.

The Federal Judicial Television Network (FJTN) is a satellite broadcast network that reaches over 300 court locations. In 2006, we produced:
—Supreme Court: The Term in Review (2005–2006), which analyzed cases likely to affect Federal court dockets;
—Implementing the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Early Experience;
—A New Mandate: Use of Conflicts Screening Software;
—The Sentencing Guidelines Statement of Reasons Form (with the U.S. Sentencing Commission);
—reviews of key bankruptcy decisions in 2005 in the Fourth, Eighth, and Ninth Circuits;
—The Fundamentals of Criminal Pretrial Practice in the Federal Courts; and
—an orientation series for new law clerks, including a program on the basics of employment discrimination law.

Web-based resource pages are available to judges on a variety of topics, such as:
—Managing habeas corpus review of capital convictions, including case-law summaries, case-management procedures, and sample case-management plans, orders, and forms (a similar resource page on federal death penalty cases has been available for several years);
—electronic discovery and evidence, including materials from Center workshops, relevant local rules and sample orders, and a bibliography of case law and articles;
—courtroom technology, including our manual on Effective Use of Courtroom Technology, and our research on videoconferencing in criminal proceedings and animation, simulations, and immersive virtual environmental technology;
—safeguarding personal information in electronic transcripts;
—selected appellate decisions on sentencing post-*Booker*;
—the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, with materials and streaming video and audio formats of our television broadcasts and audio conferences on the act;
—non-prisoner civil pro se litigation, a collection of information from district courts regarding their practices with pro se litigants; and
—streaming videos of recent FJTN broadcasts.

We also have a Web-based resource page of materials to help law clerks learn about their duties and the ethical responsibilities of their position. This includes a new e-learning tutorial.

We released or had in production the following judicial and legal education publications in 2006: The Bail Reform Act of 1984, Third Edition; Copyright Law, Second Edition; The Elements of Case Management: A Pocket Guide for Judges, Second

Edition; Managing Discovery of Electronic Information: A Pocket Guide for Judges; Mediation & Conference Programs in the Federal Courts of Appeals: A Sourcebook for Judges and Lawyers, Second Edition; Patent Law and Practice, Fifth Edition; Post-*Booker* Sentencing—Selected Issues from Appellate Case Law (online only); and The Use of Visiting Judges in the Federal District Courts: A Guide for Judges and Court Personnel (updated 2006)(on line only).

EDUCATION PROGRAMS FOR JUDGES AND COURT STAFF

In 2006 we offered several programs that judges and court staff attend together, including:

—A policy institute for district judges, probation and pretrial services officers, and prosecutors and defenders, held in cooperation with the Judicial Conference's Criminal Law Committee, the Sentencing Commission, and the Administrative Office, which included discussions on sentencing policies with representatives of the legislative, executive, and judicial branches;
—our Program for Consultations in Dispute Resolution, which provides on-site assistance to courts that wish to begin or revise alternative dispute resolution programs;
—a 2-day executive team-building program for new chief judges and their clerks of court in conjunction with the Center's national conferences for chief district and bankruptcy judges;
—four strategic planning workshops to help courts develop policy and operational plans specific to their courts;
—an executive leadership seminar for chief judges and their court unit executives;
—a workshop produced in collaboration with the Administrative Office and the General Services Administration to help court teams plan for capital construction projects; and
—at the request of a circuit court, Using Technology to Serve the Appellate Process, an in-court program developed with the Administrative Office, for judges, court unit executives and their staff, Federal defenders, and members of the bar.

EDUCATION PROGRAMS AND MATERIALS FOR COURT STAFF

The table below summarizes our programs for the staff of the courts.

EDUCATION AND TRAINING PROGRAMS FOR COURT STAFF, JANUARY 1-DECEMBERR 31, 2006

	Number of Programs	Number of Participants
Seminars and Workshops (national and regional):		
Clerks of court, clerk's office personnel, circuit executives, bankruptcy administrators, senior staff attorneys, court librarians	7	893
Probation and pretrial services officers and personnel	11	508
Personnel in several categories [1]	15	598
TOTAL	33	1,999
In-Court Programs (programs using curriculum packages, training guides, and computer-assisted instructional programs):		
Clerks of court, clerk's office personnel, circuit executives, bankruptcy administrators, senior staff attorneys, court librarians	76	1,876
Probation and pretrial services officers and personnel	100	2,967
Personnel in several categories	90	1,205
TOTAL	266	6,048
Technology-based Programs (videoconferences, audio conferences, online conferences, but not including FJTN broadcasts):		
Clerks of court, clerk's office personnel, circuit executives, bankruptcy administrators, senior staff attorneys, court librarians	6	1,881
Probation and pretrial services officers	8	186
Personnel in several categories	1	33
TOTAL	15	2,100

EDUCATION AND TRAINING PROGRAMS FOR COURT STAFF, JANUARY 1-DECEMBERR 31, 2006—Continued

	Number of Programs	Number of Participants
GRAND TOTAL	314	10,147

[1] Includes team management workshops for judges and court unit executives.

2006 programs for clerks of court and their staffs included:
—A biennial National Conference for District Court Clerks and Chief Deputy Clerks, which emphasized strategic planning, succession planning, implementing new Judicial Conference policies, management issues, and electronic case filing;
—two management training workshops for supervisors and managers in appellate, district, and bankruptcy courts—a program for those new to the position discussed such topics as performance management, while the program for those with 3 or more years of experience examined staff development and leadership during a crisis;
—several programs with the Administrative Office on Case Management/Electronic Case Filing were facilitated with our staff: three forums—one for district court staff and two for bankruptcy court staff—as well as two web-audio conferences and two audio conferences for bankruptcy courts; and
—an online conference conducted over several months for jury administrators on customer communications and a web-audio conference on best practices.

Conferences and workshops for probation and pretrial services offices included:
—A biennial National Conference for Chief Probation and Pretrial Services Officers on succession planning, management issues, optimizing efficiency through technology, offender supervision methods, and coping with limited budgets;
—an executive team workshop for chief probation and pretrial services officers and their chief deputies that helps leaders analyze district operations and create a strategic plan;
—five regional symposia for experienced supervising officers that dealt with supervision skills, staff motivation, change management and other topics; and
—two in-person workshops for new supervising officers participating in a 2-year supervisors development program that also comprises completion of a 40-hour self-study course and attendance at several web-audio conferences.

New FJTN programs in 2006 for officers included Cyber Crime Investigation and Supervision and Substance Abuse: Methamphetamine, the fourteenth program in a series. The cyber crime program and a rebroadcast of our Financial Investigation series were supplemented with five web-audio conferences.

The Center offers extensive leadership and management education through its Professional Education Institute (PEI). PEI includes courses, programs, web-based resources, and self-development tools to aid leaders and managers at all levels.

The Center has a variety of curriculum packages that Center-trained court staff or staff with training experience use to conduct training in local courthouses. Recent packages for managers in all court units include Planning for Fiscal Management, Planning for Strategic Workforce Management, and Developing a Strategic Court Web Site. A new training guide, Mentoring in the Courts, was published electronically on the Center's intranet site.

New FJTN programs for all court personnel included a program on challenges and possibilities facing the courts, an orientation video on the Center's Federal Court Leadership Program, and a program on mentoring relationships. Four editions of the Court to Court video magazine spotlighting innovative court practices aired in 2006.

RESEARCH

The Center conducts empirical and evaluative research on Federal judicial administration and case management, mostly at the request of committees of the Judicial Conference. The results of most of our research are available in print, on our web sites, or in both formats. In 2006, we completed 10 major research projects and continued work on 33 others. This research included:
—Developing and implementing a research design and training protocols for a major study of courtroom use in the district courts as requested by a committee of the Judicial Conference in response to a request from the chair of the Subcommittee on Economic Development, Public Buildings and Emergency Management of the House Committee on Transportation and Infrastructure. This extensive study of how Federal courtrooms are scheduled and actually used is sched-

uled to be completed in June 2008. The study focuses on courtroom use in a random sample of 24 districts during two 3-month time periods in 2007. Three additional districts are included in the study because they face unusual circumstances involving their courtrooms;

—producing a handbook to assist judges in managing class actions under the Class Action Fairness Act of 2005 (CAFA). Managing Class Action Litigation: A Pocket Guide for Judges concisely describes the most important and relevant practices for managing class action litigation as set out in the Center's Manual for Complex Litigation, Fourth. The handbook is a product of the Center's multi-year study of the impact of CAFA on Federal judiciary resources as requested by the Advisory Committee on Civil Rules;

—examining a sample of class action activity, including appeals, before and after CAFA went into effect, with the goal of measuring its impact on various stages of litigation, including remand, ruling on pretrial motions, ruling on class certification, trial, settlement, and appeals;

—conducting research and interviews with Federal judges who have recently been assigned terrorism cases in order to develop educational materials to for judges related to managing terrorism cases;

—assisting the Advisory Committee on Civil Rules as it considers a number of possible amendments to the rules of civil procedure;

—conducting a survey of a sample of district court judges and attorneys involved with recently terminated patent cases to identify the case management techniques that judges employed to strengthen the claim construction process;

—following up on research to our 2003 study of eleven courts' experiences as pilots in providing remote public access to electronic criminal case records. The follow-up research included an assessment of remote public access to criminal, civil, and bankruptcy electronic records in the district courts. The research focused on related issues such as redacting prohibited information in documents that are filed in the federal courts;

—examining a sample of over 700 capital habeas appeals of State convictions in response to perceived delay and backlog issues in the processing of these cases;

—developing and publishing a pocket guide to help Federal judges manage the discovery of electronically stored information: Managing Discovery of Electronic Information: A Pocket Guide for Judges;

—conducting on-going research to support the Judicial Conference's use of the recently developed statistical case weights for the district courts to assess judgeship needs, including major research to develop new statistical case weights for the bankruptcy courts; and

—supporting the Judicial Conduct and Disability Act Study Committee, appointed by Chief Justice Rehnquist and chaired by Justice Breyer, as it prepared its final report. Earlier work for the committee included reviewing a stratified national sample of complaints filed under 28 U.S.C. § 351.

We also responded to more than 50 informational requests for research-related assistance from the courts, Judicial Conference committees, State and Federal agencies, individuals from academic institutions and associations, and others.

PROGRAMS FOR FOREIGN JUDICIAL OFFICIALS

In 1992, the Center's implementing legislation was amended to include a mandate to support the U.S. Government's efforts with promoting the rule of law abroad by providing information about judicial administration and education to the courts of other countries and also to obtain information from foreign judiciaries that might assist U.S. judges manage transnational litigation. To that end, in 2006, the Center conducted 43 briefings for more than 226 foreign judges, court officials, scholars, and students from over 68 different countries; hosted visiting foreign judicial fellows from Brazil and Russia, who studied case management, intellectual property and treaty law, and judicial independence; and provided technical assistance abroad, including conference presentations, in Argentina, Jordan, Kazakhstan, Kosovo, Russia, and Serbia.

No funding for these projects came from the Center's appropriation; they were supported with funds from U.S. Government agencies and host countries (or organizations within them). The Center's two-person International Judicial Relations Office coordinates this activity. The Center also held a conference on international law and litigation for U.S. judges, in collaboration with the American Society of International Law.

FEDERAL JUDICIAL HISTORY

Congress has told us to conduct, coordinate, and encourage programs related to the history of the Federal judicial branch. Our 3-person Federal judicial history office does so by making available the results of our own historical research, helping judges and the courts with court history projects, and encouraging research and education projects about the judiciary. We have completed six units in our project to develop web-based curriculum materials to help educators teach about the history of the Federal courts, and we have conducted summer institutes that bring together teachers, judges, and scholars to study judicial history. We continue to update and expand the widely used History of the Federal Judiciary website, including the Federal Judges Biographical Directory.

PUBLICATIONS

Most Center publications are available in print and electronically. In addition to the judicial and legal education publications listed above, the Center also released the following research reports: The Impact of the Class Action Fairness Act of 2005: Second Interim Report to the Judicial Conference Advisory Committee on Civil Rules (on line only); Interim Progress Report on Class Action Fairness Act Study (on line only); Research on Appeals of Attorney-Fee and Merits Decisions (Fed. R. Civ. P. 58(c)(2)) As Presented to the Advisory Committee on Civil Rules in May 2006 (on line only); and Roundtable on the Use of Technology to Facilitate Appearances in Bankruptcy Proceedings.

FEDERAL JUDICIAL TELEVISION NETWORK

The Center operates the Federal Judicial Television Network (FJTN), a satellite broadcast network with viewing sites in more than 300 Federal court locations, making it the second largest nonmilitary television network in the Federal Government. It transmits Center educational programs as well as those of the Administrative Office and the U.S. Sentencing Commission. In 2006, the FJTN broadcast 98 programs, including 8 live programs. The Center produced 62 of these programs, 4 of which were live. The online FJTN Bulletin is a bimonthly program guide with broadcast schedules, program descriptions, and other news about the network. The Center is also streaming videos to enable judges and court staff to easily access information on their computers.

MEDIA LIBRARY

The Center's media library contains some 4,000 audio and video programs, including Center programs and almost 800 commercially produced video programs. In 2006, the media library loaned more than 600 programs to Federal judges and judicial branch personnel and sent some 2,000 media programs directly to the courts for them to keep and use in local education and training programs.

INFORMATION SERVICES

The Center serves as a national clearinghouse for information on Federal judicial administration. In 2006, Information Services Office staff answered hundreds of requests for information from judges and court staff, congressional staff, other government agencies, academics, researchers, the media, and the public.

FEDERAL JUDICIAL CENTER FOUNDATION

Congress created the Foundation to receive gifts to support Center work in certain specialized areas. Its 7-person board is appointed by the Chief Justice, the President Pro Tempore of the Senate, and the Speaker of the House of Representatives. In 2006, Foundation funds helped support our project on alternative dispute resolution and programs for judges on advanced mediation strategy, environmental and natural resources law, emerging issues in neuroscience, law and science, and humanities and science.

CONCLUSION

Again, I appreciate the opportunity to submit this statement and stand ready to answer any questions you may have.

PREPARED STATEMENT OF THE UNITED STATES SENTENCING COMMISSION

Chairman Durbin, Ranking Member Brownback, members of the subcommittee, the United States Sentencing Commission thanks you for the opportunity to submit this statement in support of the Commission's appropriation request for fiscal year 2008.

For the past 3 fiscal years, the Commission has detailed for its appropriators the significant impact the Supreme Court's decisions in *Blakely* v. *Washington* [1] and *United States* v. *Booker* [2] have had not only on the Commission but the entire criminal justice community. Despite changes in case law governing federal sentencing policy, the Commission has continued to fulfill its statutory mission as set forth in the Sentencing Reform Act of 1984. Full funding of its fiscal year 2008 request will ensure that the Commission can continue to fulfill its statutory responsibilities.

RESOURCES REQUESTED

The Commission is requesting $15,477,000 for fiscal year 2008, representing a 6 percent increase over allotted funding for fiscal year 2007. The Commission recognizes that Congress sent a strong message in passing the fiscal year 2007 continuing funding resolution that agencies should use allotted resources carefully. The Commission accordingly has tailored its request for funding to reflect the Commission's intent to be fiscally conservative while maintaining the resources it needs to meet its statutory mission.

JUSTIFICATION FOR THE COMMISSION'S APPROPRIATION REQUEST

The statutory duties of the Commission include, but are not limited to: developing appropriate guideline penalties for new and existing crimes; collecting, analyzing, and reporting federal sentencing statistics and trends; conducting research on sentencing issues in its capacity as the clearinghouse of federal sentencing data; and providing training on sentencing issues to federal judges, probation officers, law clerks, staff attorneys, defense attorneys, prosecutors, and others in the criminal justice community.

The Supreme Court's decisions in *Blakely* and *Booker* did not alter these core missions. In fact, the Supreme Court in *Booker* reaffirmed these statutory obligations by explaining that the Commission's post-*Booker* mission remained "writing guidelines, collecting information about district court sentencing decisions, undertaking research, and revising the guidelines accordingly." [3] The Supreme Court explained further that the "Commission will continue to collect and study appellate court decisionmaking. It will continue to modify its guidelines in light of what it learns, thereby encouraging what it finds to be better sentencing practices." [4]

Over the past 3 fiscal years, the Commission has worked diligently to maximize resources overall and appreciates the funding and support it has received from Congress. The Commission, therefore, has tailored its fiscal year 2008 funding request to reflect its continued commitment to efficiently yet effectively meet its core mission.

SENTENCING POLICY DEVELOPMENT AND GUIDELINE PROMULGATION

The Commission promulgated a number of amendments to the guidelines in several substantive areas of criminal law, including immigration, steroids, terrorism, firearms, and intellectual property, that became effective in 2006. For the amendment cycle ending on May 1, 2007, the Commission also is considering a number of guideline amendments, including recommendations for penalty modifications for transportation, sex, terrorism, and drug offenses, and the fraudulent acquisition or unauthorized disclosure of phone records. These proposed amendments reflect the Commission's response to the USA Patriot Improvement and Reauthorization Act of 2005, the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users, the Adam Walsh Child Protection and Safety Act of 2006, the Stop Counterfeiting in Manufactured Goods Act, the Telephone Records and Privacy Protection Act of 2006, and a number of directives and changes to the criminal law made by the 109th Congress, as well as input received from the criminal justice community, the resolution of circuit conflicts on sentencing application issues, and other policy priorities of the Commission.

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[1] 542 U.S. 296 (2004).
[2] 543 U.S. 220 (2005).
[3] 543 U.S. at 264.
[4] 543 U.S. at 263.

Consistent with the requirements of the Sentencing Reform Act of 1984, the Commission's process for sentencing policy development and guideline promulgation continues to include significant outreach to, and input from, criminal justice stakeholders, as well as the review of pertinent literature, data, and case law. The following examples of the Commission's work during the current amendment cycle illustrate this process.

As part of its ongoing study of the criminal history guidelines and its consideration of how the guidelines might be simplified overall, the Commission held 2 days of meetings to discuss these topics with over 40 individuals, including federal judges, probation officers, defense attorneys, Department of Justice personnel, and academics. In addition, as part of its review of the guidelines with respect to cocaine offenses, the Commission held a day-long hearing to elicit testimony from representatives of the criminal justice community, including law enforcement, medical and treatment experts, academics, and community groups among others. The hearing provided a record for the criminal justice community to use as it debates the future of federal cocaine sentencing policy. The Commission also invited representatives of the Department of Justice, the defense bar, and industry groups to provide input on topics such as immigration penalties, sex offenses, and intellectual property offenses during a public meeting of the Commission.

As the foregoing examples illustrate, the federal sentencing guidelines are a product of a collaborative and comprehensive process as required by the Sentencing Reform Act of 1984, including consideration of factors set forth in 18 U.S.C. § 3553(a). Full funding of its fiscal year 2008 request will ensure that the Commission can continue to meet requirements of the Sentencing Reform Act of 1984 with respect to sentencing policy development and guideline promulgation.

COLLECTING, ANALYZING AND REPORTING SENTENCING DATA

The Supreme Court's recent jurisprudence has had a significant impact on the Commission's data collection, analysis, and reporting efforts. For over 70,000 federal felony and Class A misdemeanor criminal cases annually, the Commission extracts information from five documents that the courts are required to send to the Commission pursuant to 28 U.S.C. § 994(w).[5]

Immediately after the 2004 *Blakely* decision, the Commission recognized that one of the most critical functions it could perform was reporting the most timely and accurate sentencing data available. The Commission therefore began to refine its efforts in this area so that it could produce data beyond its statutorily required annual reports. By the time the Supreme Court issued its *Booker* decision in January 2005, the Commission had revised its data collection and reporting process so that it could provide "real-time" data about the effects of the *Booker* decision on national sentencing practices.

The Commission further refined its data collection, analysis and reporting efforts throughout fiscal year 2006 to maximize the information it provides to the criminal justice community. It now provides detailed quarterly national sentencing data similar to the format and types of data produced in the Commission's year-end annual reports. Moreover, in February 2007, the Commission published on its website its Fiscal Year 2006 Annual Report and Sourcebook. These materials reflect the Commission's analysis of over 72,000 cases. This represents approximately 24,000 more cases than the Commission processed in fiscal year 1997, showing a 50-percent increase in caseload over a 10-year period. The Commission's fiscal year 2008 funding request is designed to maintain personnel and other resources in the key areas of data collection, data analysis, and research. This funding also will ensure that the Commission can keep pace with increased demands made of its data collection and analysis efforts.

Information Technology Issues Associated with Data Collection, Analysis, and Reporting

The Commission has developed and implemented an electronic document submission system that enables sentencing courts to submit electronically the five statutorily required sentencing documents directly to the Commission. This has greatly alleviated the need to spend court resources on copying, bundling, and mailing hard copies. Currently, 80 of the 94 judicial districts are using the system, with another 11 slated to come on-line within the coming months. The Commission is hopeful that all 94 districts will be using the system by the end of fiscal year 2007.

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[5] Section 994(w) of title 28, United States Code, requires the chief judge of each district court, within 30 days of entry of judgment, to provide the Commission with: The charging document; the written plea agreement (if any); the Presentence Report; the judgment and commitment order; and the statement of reasons form.

The electronic document submission system has enabled the Commission to take significant steps toward automating data collection and analysis. Increased automation contributes significantly to the success of the Commission's statutory missions and offers significant benefits to the entire criminal justice community. Automation better allows the Commission to provide the independent and objective analysis and reporting of federal sentencing practices contemplated by the Sentencing Reform Act. Automated data collection and analysis enable the Commission to provide even more detailed and accurate data on national sentencing trends to the criminal justice community. An automated system allows the Commission to work closely with other entities in the criminal justice community in creating an unparalleled system of document receipt and data reporting that promotes best practices throughout the system. By increasing internal efficiencies, the Commission is able to dedicate more resources to research-oriented tasks.

The Commission is pleased that Congress has funded its efforts to become fully automated. During fiscal year 2008, the Commission intends to evaluate the technological base it has built and, working with other entities in the criminal justice community, determine the next steps for moving forward technologically. Full funding of its fiscal year 2008 request will ensure that the Commission's automation systems work efficiently and effectively and allow the Commission to further develop its automation resources.

Increased Demands for Commission Work Product from Congress

In addition to the new demands for national data placed on the Commission by the Supreme Court's recent decisions, the Commission also continues to experience increased demand for its work product from Congress. In addition to providing its quarterly and annual data reports on national sentencing practices, the Commission is required to assist Congress in assessing the impact proposed criminal legislation will have on the federal prison population. These assessments often are complex, time-sensitive, and require highly specialized Commission resources. Throughout the past 3 fiscal years, the Commission also has experienced an increase in more general requests for information from Congress on issues such as drugs, gangs, immigration, and sex offenses. The Commission anticipates an even higher volume of such requests throughout fiscal year 2008 and looks forward to fulfilling these requests in a timely and thorough manner.

CONDUCTING RESEARCH

Research is a critical component of the Commission's overall mission. Congress directed the Commission to establish a research agenda as part of its role as the clearinghouse on federal sentencing statistics and policy. As such, the Commission has undertaken a number of important research projects. In response to the recent Supreme Court decisions and as a result of the Commission's success with increasing its data collection and analysis efficiencies, the Commission has accelerated its research agenda. In fiscal years 2006 and 2007, the Commission undertook a number of internal and external reports that provide detailed examinations of key policy areas such as immigration, drugs, and firearms offenses. Also in fiscal year 2006, the Commission released a comprehensive report on the impact of *Booker* on federal sentencing.

In fiscal year 2007, the Commission also anticipates reviewing and releasing reports on federal cocaine policy and various components of offender criminal history, along with review of other reports drafted to support the Commission's guideline amendment work. These reports are crucial to the Commission's overall objective of promulgating reasoned and well-informed guideline and policy statement amendments.

In fiscal year 2008, the Commission expects that its research agenda will include additional reports associated with its policy work and the continuation of its comprehensive review of criminal history, including more reports based on its nationally recognized recidivism database. The Commission also anticipates undertaking several research and data analysis projects of interest to the criminal justice community. Full funding of its fiscal year 2008 request will allow the Commission to pursue its commitments to providing the criminal justice community with the most comprehensive and thorough reports on federal sentencing practices.

TRAINING AND OUTREACH

The Commission is dedicated to providing specialized guideline training and technical assistance to federal judges, probation officers, law clerks, staff attorneys, prosecutors, and defense attorneys by providing educational programs throughout the year. The Commission continues to expand its training and outreach programs

to ensure the criminal justice community has the tools necessary to operate in a post-*Booker* sentencing world. Throughout the remainder of fiscal year 2007, the Commission anticipates holding training programs in all 12 circuits and a majority of the judicial districts. The Commission will co-host an annual training program for several hundred participants in May 2007 in Salt Lake City, Utah, and in May 2008 in Florida. Full funding of its fiscal year 2008 request will allow the Commission to continue its expanded training program in all 12 circuits and its attendance at numerous academic and judicial programs and symposia on federal sentencing.

SUMMARY

The Commission is uniquely positioned to assist all three branches of government in ensuring sound and just federal sentencing policy. An independent agency housed in the Judicial branch, the Commission is an expert bipartisan body of federal judges, individuals with varied experience in the federal criminal justice system, and ex-officio representatives of the Executive Branch whose work on sentencing policy must be reviewed by Congress. In short, the Commission is at the crossroads of where the three branches of government intersect to determine federal sentencing policy.

The Commission has worked hard and performed well with the resources available, and it appreciates the funding it has received from Congress to meet its increasing needs. Full funding of the Commission's fiscal year 2008 request will ensure that the Commission continues to fulfill its statutory missions to develop appropriate guideline penalties, collect, analyze, and report federal sentencing statistics and trends, conduct research on sentencing issues, and provide training to the federal criminal justice community. The Commission respectfully requests that Congress support fully the Commission's fiscal year 2008 appropriation request of $15,477,000 so that it can continue its role as a leader in federal sentencing policy.

Senator DURBIN. Mr. Duff.

STATEMENT OF JAMES C. DUFF, DIRECTOR, ADMINISTRATIVE OFFICE OF THE U.S. COURTS

Mr. DUFF. Good afternoon, Chairman Durbin and Senator Allard. I'm very pleased to present the budget request for the Administrative Office of the U.S. Courts today.

FISCAL YEAR 2007 FUNDING

I'd like to join Judge Gibbons in thanking you for the additional funding for 2007 that you gave to the judiciary above a hard freeze. We certainly appreciate the priority shown to the judiciary.

This funding will support current onboard staffing levels and base operating requirements, and also allow some staffing increases in courts where workload is heavily impacted by immigration and other law enforcement initiatives.

Although I have appeared at several budget hearings before, when I was administrative assistant to Chief Justice Rehnquist, this is the first time I've been permitted to speak at one of these hearings, and I hope you don't conclude that there was a good reason for that.

I'm honored to be here on behalf of the Administrative Office of the U.S. Courts and the court system. I did work closely with this subcommittee's predecessor, the Commerce, Justice, State, Judiciary Subcommittee, and I look forward to working with you in the newly formed Financial Services and General Government Subcommittee.

ROLE OF THE ADMINISTRATIVE OFFICE

This past July, Chief Justice Roberts appointed me to be the seventh Director of the Administrative Office of the U.S. Courts. The AO was created by Congress in 1939, and its mission is to assist

Federal courts in fulfilling the mission to provide equal justice under the law.

The AO is a unique entity in the Federal Government. It's not the sole headquarters for the courts. The Federal courts are, to some degree, decentralized. But the AO does provide administrative, legal, financial management, program, security, information technology, and other support services, to all Federal courts. It also provides support and staff counsel to the Judicial Conference of the United States and its 25 committees. And it helps implement Judicial Conference policies, as well as applicable Federal statutes and regulations.

The AO has matured over the years to meet the changing needs of the judicial branch, but service to the courts has been, and remains, our basic mission at the AO.

This year being a transition year at the AO, it's a natural time to ensure that the structure and services provided by the Administrative Office are cost effective and that they address the needs of the courts. But even if this period of transition were not a convenient time to take a look at our services and our structure, it's likely that budget constraints would have required us to do so.

I am assembling a small advisory group of judges and leaders from court personnel and within the AO to assist me in an internal review of the Administrative Office of the Courts to ensure that we are structured properly and efficiently to meet the needs of the courts and to determine if any internal adjustments are needed to become more efficient.

COST CONTAINMENT

Cost containment within the AO is also an important priority. And when I came onboard last July, one of the things we did was to put in place a hiring freeze within the AO which continues. We have not sought to replace vacancies from outside the organization. We've tried to backfill within the organization, and, I think, have obtained substantial savings as a result of that effort. There have been exceptions to it, but they are the exception and not the rule.

RELATIONSHIP WITH GENERAL SERVICES ADMINISTRATION

On another front—Senator Allard, you referred to this—I think it's fair to say that relations between the courts and the GSA have been strained over the past few years. I'm very pleased to report some progress with GSA. We've had a number of meetings and discussions with the new Administrator at GSA. We are getting to the bottom of these rent overcharges that have occurred. What I'm most pleased about is that the nature of the dialogue and the tone of the dialogue have improved. We're sitting across the table from each other and working through some of these problems. We've exposed a number of the rent overcharges and have been given credit for them. The total amount of these is over $50 million.

Another thing we're doing with GSA is trying to devise a new formula for going forward on our rent. The current basis for determining rent is based on a fair market value, and there's been a lot of room for play in that. And that's where we have identified some of these overcharges.

We're working with them on a new formula for making rent calculations, going forward, more attuned to a return-on-investment formula, which gives us some predictability, which is great for us, with regard to planning—budget planning, and, as I say, takes some of the play out of the rent calculations that have been troublesome to us.

The goal, frankly, is to come to you in the future with a solution to these problems, rather than to put into your lap a significant problem that requires your intervention for a solution. We're very grateful, however, having said that, for your intervention and the pressure you've helped bring to bear on a very significant problem within the judiciary. It's been extremely helpful and we appreciate it, Senator Allard.

FISCAL YEAR 2008 REQUEST

My written testimony, which I ask be included in the hearing record, provides several examples of the wide array of services and support that the AO provides to the Federal judiciary. I'm going to limit the remainder of my remarks this afternoon to the specific budget request, the fiscal year 2008 budget request for the AO.

The fiscal year 2008 appropriations request for the Administrative Office of the U.S. Courts is $78,536,000. This is an increase of $6.2 million over the 2007 enacted level. And, while the increase we're seeking may appear to be significant, it actually represents a no-growth current-services budget. Mr. Chairman, the AO's appropriation comprises less than 2 percent of the judiciary's total budget.

In addition to the appropriation provided by this subcommittee, the AO receives nonappropriated funds from fee collections and carryover balances, as well as reimbursements from other judiciary accounts for information technology development and support services that are in direct support of the courts, and the court security and defender services programs. The principal reason for the increase in appropriated funds requested for the AO is to replace nonappropriated funds that were used to finance the fiscal year 2007 financial plan, but which are expected to decline in fiscal year 2008. And mostly, there, we're talking about reductions in bankruptcy filings. The filing fees from bankruptcy filings funded significantly our nonappropriated funds in the past. And, because of the anticipated drop off in those nonappropriated funds, we are seeking more in the way of appropriated funds.

I would emphasize that we are requesting no program increases in our budget request. I would also emphasize that of course we're going to keep you apprised and work closely with your staff if our projections of fee collections and carryover estimates change. If we experience and obtain additional fee collections from those which we've projected, we'll certainly inform you right away of that fact, so adjustments to the AO's budget request can be made accordingly.

PREPARED STATEMENT

Chairman Durbin and members of the subcommittee, I recognize that fiscal year 2008 will be another difficult year for you and your colleagues as you struggle to meet the funding needs of agencies

and programs that are under your review. I pledge to you that we will work very closely with you, and we treat, as seriously as you do, cost-containment efforts and initiatives. And we look forward to working with you and your staff.

Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF JAMES C. DUFF

INTRODUCTION

Chairman Durbin, Senator Brownback, and members of the subcommittee, I am pleased to appear before you this afternoon to present the fiscal year 2008 budget request for the Administrative Office of the United States Courts (AO) and to support the overall request for the entire Judicial Branch.

Before I begin, I would like to join Judge Gibbons in thanking you and your committee for the support you provided the Judiciary in H.J. Res. 20, the final 2007 Continuing Resolution. We deeply appreciate the additional funding above a hard freeze provided the Judiciary. It will support current on-board staffing levels and base operating requirements, and allow some staffing increases in courts whose workload has been heavily impacted by immigration and other law enforcement initiatives.

While this is my first official appearance before Congress, from 1996 to 2000 I served Chief Justice Rehnquist as his administrative assistant and chief of staff and supported Justices Souter and Kennedy in their appearances before then-Chairman Gregg and the Commerce, Justice, State, and the Judiciary Appropriations Subcommittee. I look forward to working with you under the newly formed Financial Services and General Government Appropriations Subcommittee, to answer any questions you might have, and to represent as clearly as I can the important needs of the Federal Judiciary.

ROLE OF THE ADMINISTRATIVE OFFICE

In July 2006, I accepted the appointment of Chief Justice Roberts to become the 7th Director of the Administrative Office of the U.S. Courts. Created by Congress in 1939 to assist the Federal courts in fulfilling their mission to provide equal justice under law, the AO is a unique entity in government. Neither the Executive Branch nor the Legislative Branch has any one comparable organization that provides the broad range of services and functions that the AO does for the Judicial Branch.

Unlike most Executive Branch agencies in Washington, the AO is not the sole headquarters for the courts. The Federal court system is decentralized, although the AO provides administrative, legal, financial, management, program, security, information technology and other support services to all Federal courts. It provides support and staff counsel to the Judicial Conference of the United States and its 25 committees, and it helps implement Judicial Conference policies as well as applicable Federal statutes and regulations. The AO also coordinates Judiciary-wide efforts to improve communications, information technology, program leadership, and administration of the courts. Our administrators, accountants, systems engineers, analysts, architects, lawyers, statisticians, and other staff provide professional services to meet the needs of judges and staff working in the Federal courts nationwide. The AO staff also responds to congressional inquiries, provides information on pending legislation, and prepares congressionally mandated reports.

The AO has evolved and matured over the years to meet the changing needs of the judicial branch. Service to the courts, however, has been and remains our basic mission. As its new director, I want to ensure that the structure and services provided by the AO are appropriate and cost-effective and that they address the needs of the courts. I am assembling a small advisory group of judges and leaders from court personnel to assist me and our new deputy director—Jill Sayenga—in a review of our structure. Ms. Sayenga brings with her 18 years of experience in the Federal court system and will be a great asset to the AO. We are currently engaged in an examination of our core mission as defined by statutes and directives from the Judicial Conference to determine if internal adjustments are needed within the AO to improve efficiency and responsiveness to the courts.

WORKING WITH OUR EXECUTIVE BRANCH PARTNERS

Relations between the General Services Administration (GSA) and the AO in recent years have been strained. During the past 8 months I have served as director, I have met many times with Ms. Lurita Doan, the new GSA administrator, and the new commissioner of the Public Buildings Service, David Winstead, to work on solutions to the issues confronting our organizations and identify our mutual goals and responsibilities. I am pleased to report significant progress in the relationship between the AO and GSA. We are working together on our extensive nationwide effort to validate GSA space assignment and classification records, and to reconcile them with actual rent bills. In addition, we are currently working on significant changes in how GSA determines or calculates courthouse rents. We both recognize the important responsibility our agencies have in being good stewards of limited federal funds. Our negotiations reflect the partnership that is being forged and my firm belief that developing cooperative relationships and maintaining open lines of communication with our Executive Branch partners is crucial to our ability to solve problems as they arise. It is our mutual goal to present solutions to Congress to the issues facing us, and not delivering problems to you.

Judicial Security

Another important Executive Branch partnership we have is with the United States Marshals Service (USMS). By statute, and under a Memorandum of Agreement with the Attorney General, the Congress appropriates funds to the Judiciary to provide security inside Federal courthouses, and these funds are administered by the USMS for the Judiciary through its judicial security program. A close working relationship between the AO and the USMS is essential to ensure the protection of the judicial process, including litigants, judges, and the public. In addition, it is critical that the administration support, and Congress provide, the resources necessary for the USMS to fulfill adequately its statutory mission.

John Clark, a career U.S. Marshal, and relatively new director of the USMS, has been very accessible to the AO and we are building a stronger working relationship with the USMS. Director Clark has attended each of the meetings of the Judicial Conference's Judicial Security Committee since it was created in January 2006 and has encouraged his senior staff to meet regularly with AO staff to discuss issues and implement policies regarding judicial security. This improved relationship with the USMS will enhance the security of the Judiciary.

Following the murders of two members of U.S. District Court Judge Joan Lefkow's family in their Chicago home, the Administrative Office worked with Director Clark and the Appropriations Committees—especially you Chairman Durbin—to obtain supplemental funding for the USMS to enhance the off-site security of Federal judges. Part of the supplemental funding was used by the USMS to establish a home-intrusion detection systems program for all Federal judges. The AO and the USMS worked together to develop a program to provide home alarm systems to Federal judges who wanted one. To date, nearly 1,600 systems have been installed or are scheduled for installation in judges(homes by a USMS national security vendor.

THE ADMINISTRATIVE OFFICE—IN SERVICE AND SUPPORT

Each day, as judges and court employees across the country work to provide citizens with due consideration and equal justice under the law, the Administrative Office supports that commitment by designing and carrying out programs and initiatives in a manner that reflects good stewardship of public funds. From the implementation of cost-containment initiatives to carrying out congressional mandates, AO staff collaborate with the courts to design and implement smart business practices. I would like to highlight just a few.

Judiciary Internal Oversight and Review

The Administrative Office plays a vital role in the Judiciary's system of oversight and review to promote the stewardship of resources, effective program management, and the integrity of operations within the Third Branch. The AO has been conducting financial audits since Congress first authorized this function in 1975.

The AO's comprehensive audit program complies with generally accepted government audit standards. In 2006, the AO conducted 105 financial and administrative audits of Judiciary funds, financial activities, operations and systems. Financial audits covering all court units are conducted by an independent certified public accounting firm under contract with and the direction of the Office of Audit on a 4-year cycle for most courts, and on a 2½ year cycle for larger courts. Other audits cover funds such as the Court Registry Investment System, Judiciary Retirement Trust Funds, Chapter 7 trustees, Criminal Justice Act (CJA) grantees, contracts and

financial systems, and special audits such as when there is a change of court unit executive.

In addition, on-site programmatic reviews are conducted in the courts. These specific reviews may focus on things such as program operations and management, human resources management, procurement, information technology operations, security, continuity of operations planning and disaster preparedness, as well as jury management and court reporting in district courts. During fiscal year 2006, on-site reviews covering program and technical operations were conducted in three appellate courts, seven district courts, four bankruptcy courts, 14 Federal defender organizations, and 12 probation and pretrial services offices.

The AO provides investigatory services for addressing allegations of waste, fraud, or abuse. This program was approved by the Judicial Conference in 1988, and the Judicial Conference's Committee on the AO oversees the AO's performance of this function. In addition, the AO has a liaison with the Department of Justice's Criminal Division, the Government Accountability Office's FraudNet operation, and others for the referral and appropriate resolution of allegations of impropriety.

Ethics Compliance

The Judiciary also has mechanisms in place to address allegations of judicial misconduct or disability. Like Congress, the Judiciary addresses conduct and ethical matters with self-regulating policies and through committees of Federal judges. Accountability is a core value of the Judiciary, and the Judiciary's self-imposed standards of conduct are stringent.

Last September, the Judicial Conference adopted two policies to aid judges in complying with established ethical obligations. The first requires all Federal courts to use conflict-checking software to assist judges in identifying cases in which they could have a financial conflict of interest and should therefore recuse themselves. While automated screening is not foolproof, it is an efficient and effective supplement to a judicial officer's individualized review. The second outlines new disclosure requirements for those who provide privately-funded educational programs for judges and the judges who attend such programs. The policy requires seminar sponsors to disclose sources of funding, topics, and names of speakers. Judges are barred from accepting reimbursements unless the program providers have made the required disclosures. Judges must report their attendance within 30 days after the program. Disclosures already are available on the Internet. The Administrative Office is actively engaged in the implementation of these policies. Working closely with the relevant Judicial Conference committees, AO staff drafted guidelines, developed training programs, and created automated reporting systems to support these new Conference policy initiatives.

Remote Access for Officers Working in the Community

Through its Office of Probation and Pretrial Services, the AO continues to provide probation and pretrial services officers with various wireless technologies to enhance their productivity while in the community interacting with defendants and offenders. Officers now have all critical information about persons under their supervision at their fingertips via "smart phones" and wireless hand-held devices and laptops. Not only do officers working in the community have access to all of the information that is available in their offices, they also are able to transmit information from remote locations back to the office. These technologies save travel time and expenses and make it possible for officers to spend more time in the community supervising offenders. Using remote technology was imperative to our success in tracking offenders in the aftermath of the Gulf Coast hurricanes.

Case Budgeting

Recently issued Judiciary guidelines encourage courts to utilize case budgeting for high-cost Criminal Justice Act (CJA) panel attorney representations. These high-cost representations total less than 3 percent of the caseload but account for about one-third of the panel attorney expenses. To assist in this effort the Second, Sixth, and Ninth circuits were selected to participate in a pilot project and each will receive one position to support the case-budgeting process in courts within these circuits for up to 3 years. The AO has contracted with two expert litigators who have substantial case-budgeting experience to assist judges in assessing whether Criminal Justice Act case budget estimates are reasonable. The Defender Services appropriation is one of the fastest growing accounts within the Judiciary and we are hopeful that case budgeting will be helpful in controlling expenditures in high-cost—usually capital case-representations.

Report on the Impact of the Supreme Court Booker Case on the Judiciary's Workload

The Supreme Court, in *Blakely* v. *Washington,* 542 U.S. 296 (2004) (*Blakely*), invalidated a sentence imposed by a State court under the State's sentencing guidelines system. In doing so, it raised questions about the constitutionality of the Federal sentencing guidelines system. The Supreme Court decision in *United States* v. *Booker* 543 U.S. 220 (2005) (*Booker*), issued a year later, rendered the Federal sentencing guidelines advisory in nature, rather than mandatory.

In a June 2006 report requested by the House and Senate Appropriations Committees, the AO documented that the Supreme Court decisions in *Blakely* and *Booker*, had significantly impacted the workload of the Federal courts, as thousands of convicted defendants filed appeals or habeas corpus petitions contesting the legality of their sentences and thousands of cases already on appeal were remanded back to the trial courts for resentencing. This detailed analysis of the impact the *Blakely*/*Booker* decisions have had on the workload of the appeals and district courts, Federal defenders, and probation officers has been extremely helpful in determining resource needs and the allocation of appropriated funds.

Increased Productivity Through Information Technology Systems

Another key AO responsibility is to lead and manage the development, implementation, and support of new information technology systems that will enhance the management and processing of information and the performance of court business functions. By the end of 2006, the Federal courts' Case Management Electronic Case Files (CM/ECF) system was operating in all bankruptcy courts, and 92 of 94 district courts, as well as the Federal Court of Claims and the U.S. Court of International Trade. The appellate courts' new case management system is scheduled to be fully deployed in nearly all regional courts of appeals by the end of this year.

The prototype system for what is now CM/ECF was launched in 1995 when a team from the AO helped the U.S. District Court in the Northern District of Ohio manage more than 5,000 document-intensive maritime asbestos cases. That court faced up to 10,000 new pleadings a week—a workload that quickly became unmanageable. Together, the team developed a system that allowed attorneys to file and retrieve documents and receive official notices electronically. A year later, the Bankruptcy Court in the Southern District of New York began live operations with a similar system that the AO had tailored for bankruptcy court needs. That court faced some of the early mega-bankruptcies, and was inundated with paper. Those early prototype efforts led to the system that now provides information on 28 million Federal court cases and serves hundreds of thousands of attorneys and litigants nationwide. Through the Judiciary's Public Access to Court Electronic Records (PACER) program most, if not all, appellate, district, and bankruptcy courts' websites contained the material now required by the E-Government Act of 2002 long before its enactment.

The implementation of CM/ECF is the largest system development and implementation effort ever undertaken in the Judiciary and is clearly one of our greatest success stories. More than 415,000 attorneys have registered and been trained in CM/ECF and on average, nearly 200,000 docket entries are made each workday. However, during one extraordinary period—the first weeks of October 2005—that volume more than doubled. And through the PACER system, CM/ECF answers more than 1,000,000 queries per workday. The system provides lawyers, the media, and any interested party with access to important case documents from anywhere, at any time, and replaces what had previously been a burdensome, labor- and paper-intensive responsibility. Attorneys have praised the systems, noting that they are easy to use, reduce their service and copying expenses, and provide quick notice of actions. It is clear that a robust information technology program makes the Federal Judiciary more accessible and efficient.

Veterans' Court of Appeals

Recognizing the success of the Judiciary's Case Management/Electronic Case Filing System and looking for the cost efficiency of adapting our new appeals court system to one that could serve their needs, the U.S. Court of Appeals for Veterans Claims approached the AO for assistance. After ensuring that our system could be adapted for their use without compromising our own security, and with the approval of the Judicial Conference, the AO entered into a Memorandum of Understanding to train and support the court in its examination and implementation of the product. The Military Construction Appropriations Subcommittees and the Veterans Affairs Committees in the House and Senate were very supportive of this agreement and the savings this partnership can bring to the Federal Government.

IT Cost Containment Initiatives

During 2006, the AO also continued its efforts to assist the Judicial Conference Committees in developing and implementing cost containment strategies that will hold down costs while maintaining the quality of judicial services. Our efforts in the area of Information Technology are one example where we have been focusing on ways to leverage limited funds to deliver useful technologies while reducing operating costs.

The Information Technology Committee was asked by the Executive Committee of the Judicial Conference to examine how we deploy computer servers for running and backing up national applications—such as our accounting, probation case management, electronic case filing, e-mail, and jury management systems. Our model had been to put servers in each court headquarters for each of those national applications. From a technical standpoint, such a server deployment model was not always necessary.

So, under the direction of the IT Committee, the AO undertook a comprehensive study—working together with many program offices, a group of court unit executives, IT professionals and a judge—to determine how best to consolidate and share the thousands of servers deployed throughout our court system. The AO is now in the process of implementing some of their recommendations.

In the probation/pretrial services area, we are in the process of consolidating 95 servers into two locations, which is projected to save $2 to $3 million over 4 years in equipment, staff support, and maintenance costs. In jury management, the working group recommended eliminating separate servers for each court by consolidating jury management onto the courts' CM/ECF servers. This is projected to save about $4 million over 5 years. We have also saved significant dollars in the courts by obtaining enterprise-wide licenses for such software as Adobe Acrobat Professional, instead of each court purchasing its own.

ADMINISTRATIVE OFFICE COST CONTAINMENT

Cost containment is also an important priority within the Administrative Office. When I became director in July, in an effort to control staffing costs, I restricted recruitment actions for filling vacant positions to internal AO sources. Any exceptions for external recruitment are scrutinized carefully by an executive review committee and require my approval. And, as part of the larger comprehensive review of the AO now ongoing, we will also be looking at AO spending, staffing, and operations to ensure that the agency is carrying out the business of the Judiciary in the most efficient and effective manner.

In addition to tight staffing restrictions, during 2006 the AO implemented a number of other internal cost-containment initiatives such as: Shifting many publications to electronic format whenever possible; reducing library materials in favor of electronic resources; and replacing desktop automation equipment based on necessity rather than on a cyclical basis.

ADMINISTRATIVE OFFICE BUDGET REQUEST

The fiscal year 2008 appropriations request for the Administrative Office of the U.S. Courts is $78,536,000, representing an increase of $6,159,000, or 8.5 percent, over fiscal year 2007 available appropriations. While the percentage increase in appropriations we are seeking may appear significant, overall it represents a no-growth, current services budget request.

The AO's appropriation comprises less than 2 percent of the Judiciary's total budget. In addition to the appropriation provided by this committee, the AO receives non-appropriated funds from sources such as fee collections and carryover balances to offset appropriation requirements. The AO also receives reimbursements from other Judiciary accounts for information technology development and support services that are in direct support of the courts, the court security programs, and defender services.

The principal reason for the large increase in appropriated funds requested for the AO in fiscal year 2008 is to replace non-appropriated funds (fee/carryover) that were used to finance the fiscal year 2007 financial plan, but which are expected to decline in fiscal year 2008 mostly because of reductions in bankruptcy filings. Specifically, the AO requires $6.2 million in base adjustments to maintain current services. This includes inflationary adjustments and increased costs for recurring requirements, such as communications, service agreements, and supplies. The AO requests no program increases, and during fiscal year 2007, I expect our hiring freeze will result in the reduction of 10 FTE's below fiscal year 2006 staffing. We will keep you apprised of actual fee collections and carryover estimates as the year progresses. If collections surpass our estimates, the amount we are requesting could be reduced.

However, if declining fee and carryover projections materialize, and they are not replaced with direct appropriated funds, we will be forced to reduce current on-board staffing. These staffing losses would come on top of the 10 FTE's reduced in the hiring freeze this year. This would, in turn, adversely affect our ability to carry out the AO's statutory responsibilities and serve the courts.

CONCLUSION

Chairman Durbin, Senator Brownback, members of the subcommittee, in the interest of time, I have shared with you only a few examples of the wide array of services and support the Administrative Office provides the Federal Judiciary, but I hope you will understand more about the function and responsibilities of our agency during the coming months. In addition to our service to the courts, the AO works closely with the Congress, in particular, the Appropriations Committee and its staff, to provide accurate and responsive information about the Federal Judiciary. I recognize that fiscal year 2008 will be another difficult year for you and your colleagues as you struggle to meet the funding needs of the agencies and programs under your purview. I urge you, however, to consider the significant role the AO plays in supporting the courts and the mission of the Judiciary. Our budget request is one that does not seek new resources for additional staff or programs. I hope you will support it.

Thank you again for the opportunity to be here today.

I would be pleased to answer your questions.

Senator DURBIN. Mr. Duff, thank you very much. And, Judge Gibbons, thank you for joining us.

I've got a host of topics here, and I'll have 5 minutes, so I'll start with them, and then Senator Allard will have an opportunity, and then I'll come back.

FEDERAL PROTECTIVE SERVICE SECURITY

The first thing I want to talk about is the Federal Protective Service. I really didn't know this was the situation until I prepared for this hearing. We kind of joke, around Washington, about the fact that, when it comes to food safety, we have an agency responsible for cheese pizza and another agency responsible for pepperoni pizza. And I'm not kidding. But this comes as a surprise to me, that the perimeter of your buildings is under the jurisdiction of the Federal Protective Service, an agency within the Department of Homeland Security. The Federal Protective Service money comes through the appropriation to the Department of Homeland Security, and, of course, the U.S. Marshals Service through your appropriation directly to them. And that is kind of curious, in and of itself. And then I read that the Federal Protective Service has had a series of problems and difficulties here. This doesn't appear to be a new problem; this appears to be a recurring problem. Would you like to comment on just how bad this is?

Judge GIBBONS. Well, obviously it's of sufficient concern to us that it was included in my written testimony. The language we used is straightforward. It's important enough that the Judicial Conference felt compelled to take a position on it and to seek a change in our situation with respect to responsibility for our exterior perimeter security. So, it is an important issue to us.

Obviously, we all have much more heightened awareness today than we did a number of years ago of the need for such security, and we are reluctant to let these things go once we find out about them and realize that we are not having difficulties that are of an isolated nature.

Senator DURBIN. I take this very seriously. We had a situation in Chicago, a few years back, involving a judge whom I appointed

to the bench, a tragedy that befell her family because of lack of security.

Judge GIBBONS. Of course, that touched all of us very much.

Senator DURBIN. And I've really tried to work with Senator Obama to not only address our situation in Illinois, but nationally, as well.

Here's what I'd like to propose. I'm going to ask that the Federal Protective Service, or if it's the Department of Homeland Security, whatever, that some representative of that agency meet with me, as well as with the U.S. Marshals Service, and Mr. Duff, if you're available——

Mr. DUFF. Yes, sir.

Senator DURBIN [continuing]. I'm going to invite Senator Byrd, who is chair of that Subcommittee on Homeland Security, and the ranking members of this committee and that, as well, to come to my office and have a conversation about the situation. I am inclined, at this point, to try to devise a way to transfer the money out of the Federal Protective Service into the Marshals Service and be done with it, but I want to hear their side of the story and see if there is something which can be done or something in transition which makes sense.

SECURITY OF JUDGES

If I could ask one other question on security, one of the things we've tried to do is make the homes of the members of the judiciary safer as a result of our continued concerns. Can either of you comment on whether or not that effort has shown any results?

Judge GIBBONS. Over 1,400 security systems have been installed in judges' homes and there are 200 security systems left to be installed. Money is available to continue to monitor those systems and to install systems for new judges who are appointed. The remainder of the judges, either for one reason or another, did not want systems, or many of them, doubtless, had previously purchased their own.

Senator DURBIN. There was also a concern about financial disclosure statements.

Mr. DUFF. Yes.

Senator DURBIN. About information that judges were required to disclose which may compromise their safety.

Mr. DUFF. Yes, sir.

Senator DURBIN. And we have been in the midst of that battle. And I don't think it's been resolved in Congress, as it should have been, as of today. Could you comment on that?

Mr. DUFF. Yes, Mr. Chairman. And first let me thank you personally for your leadership on these security issues. It's very much appreciated, and we're grateful for the support you've given.

On the financial disclosure redaction authority, the authority to redact information on financial disclosure reports had a life cycle, if you will, and it expired. And so, we need an extension of that authority from Congress, which, frankly, we had hoped would have been done in the last Congress, but did not get completed. And so, we're working very hard with both the Senate and the House to——

Senator DURBIN. I promise you, we'll return to that. That's something that should have been done, there shouldn't have been a question.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

We had—I want to follow up on your security question a little bit. A USA Today article—and it's a recent article—reported about a U.S. Marshals Service official who allegedly misspent $4.3 million meant for courthouse security and witness protection, to pay for fitness centers and firing ranges at Federal buildings. My question is, were these funds that had been appropriated to the judiciary through the court security appropriation and transferred to the Marshals Service?

Judge GIBBONS. Our information is that they were not funds appropriated to the judiciary.

Senator ALLARD. I see.

Judge GIBBONS. The funding in question was appropriated directly to the Department of Justice.

FEDERAL PROTECTIVE SERVICE SECURITY

Senator ALLARD Okay. And, on the FPS issue, the chairman suggested moving those duties over to the Marshals Service. I hope that you would also look at the possibility of privatizing this. Private security firms already guard a vast majority of Federal buildings and—to improve efficiency without sacrificing security—and I'd like to hear some of your thoughts on privatizing security of the Federal courthouses.

Judge GIBBONS. Well, statutorily, the Marshals Service, has responsibility for the security at Federal courthouses. They do contract, to a limited extent, for the services of court security officers. And I don't know what firm is currently being used, but there is a private firm being used.

The court security officers perform functions where it's deemed appropriate for a lesser degree of security. Many of them are retired law enforcement. They man the equipment at the doors of the Federal buildings. They patrol the interior hallways. They provide in-courtroom security when the case is considered low security enough not to require the services of a marshal. The marshals do continue to handle all of the transporting of prisoners and defendants being held in custody. The Marshals Service also contracts for the housing of the prisoners, in some cases, in private facilities.

Senator ALLARD. But, no matter what—I mean, if we were to change the agency or decide to do more privatization, there's going to be—have to require a change in the law, is that it?

Judge GIBBONS. Well, I think—you know, I——

Senator ALLARD. Potentially. We just have to look at that. You can put it that way.

Judge GIBBONS. We'd have to look at it. I think so, but I did not look at the statute in preparation for this hearing.

Senator ALLARD. Okay. Well, we might have a little different perspective on that. But at least I think we need to look at all options on that.

[The information follows:]

The Administrative Office of the U.S. Courts believes that a statutory change would be the best course of action in order for the U.S. Marshals Service to assume security functions at court facilities that are currently being performed by the Federal Protective Service.

WORKING WITH THE GENERAL SERVICES ADMINISTRATION

Senator ALLARD. Also, in your testimony, I was pleased to hear that you're working together with the GSA. And there's some questions. Has this affected judges to the point where there's—you had to cut staff and resources with this issue because they were taking so much for rent?

Judge GIBBONS. From time to time we have had real concerns about maintaining staff to pay the rent. And at times we have had to cut staff because we did have to pay the rent and other must pay expenses. That particularly happened to us in fiscal year 2004, largely as a result of an across-the-board cut. Since that time, we have worked really hard on containing our rent costs, and we have a lot going on in that area. We are very hopeful that we will not have to compromise staffing again to pay the rent.

Senator ALLARD. And a follow-up, there's—I assume it's had some impact on whether you construct new Federal courthouses.

Judge GIBBONS. Well, yes. The Judicial Conference adopted a cap on rent of an average of 4.9 percent increase per year, and the effect that that has on the building of Federal courthouses is that we now must take into account the fact that we're going to have to pay rent for these facilities in the future. So, that is a much greater part of our planning process than it was previously.

Senator ALLARD. So, how's your dollars going to go further? I mean, some agencies saying that it's better to rent, contract out, some say it's better to just go build your own facility. So, from what point of view are you looking at this, or are you looking at sort of a mixed view?

Judge GIBBONS. I think a mixed view. Jim may want to address that further.

Mr. DUFF. It is a mixed view. But I would emphasize—re-emphasize that the judiciary is taking very seriously cost containment and projections of rent, going forward. And imposing these rent caps on ourselves internally, on our own, is, we hope, a demonstration of our good-faith efforts to hold down, as best we can, our rent costs. And that does have an impact on courthouse construction. It keeps us on a reasonable pace for rent increases.

I, frankly, had a hard time understanding the whole concept of rent when I became Director of the AO. It just seemed very odd to me that we would be paying rent for our own buildings. But I think that is—it's a reality that we work with GSA on. And we have a long way to go with GSA, but, as I said earlier, I'm very pleased with the tone of the dialogue, and we're going to work hard together to try to come up with solutions to these problems, rather than throwing the problems in your lap.

Senator ALLARD. That's good news.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator.

PANEL ATTORNEY RATE INCREASE

Let me address this issue about the pay increases for panel attorneys. The recommendation, as I understand it, for noncapital cases, is to increase the rate to $113 per hour for the next fiscal year. And I've read a little bit here in your testimony, and a little bit of history here, that indicates that part of this has to do with the fact that—we're familiar with this, as Members of Congress—part of it has to do with the fact that there were years where there were no increases; and so, there was no effort for—or there was, in effect, no cost-of-living adjustment for the rate that was paid. And now, the suggested increase would move, I think, from $94 to $113, which, by my quick calculations in my head, is somewhere a little over 20 percent increase.

First, let me ask you about these attorneys, these panel attorneys in noncapital cases. What kind of requirements are there for these attorneys to serve on those panels?

Judge GIBBONS. Well, districts set their own requirements, but generally the requirements are geared to making sure that attorneys who are members of the panel are competent to represent defendants in the sort of cases we have in Federal court. So, for example, a court might decide not to put a brand-new attorney on the panel until the attorney has gained some experience, perhaps being mentored by another attorney, or if an attorney fails to perform well, is not conscientious about representing the client, then the court might not want to appoint that attorney anymore. So, there's no standardized set of qualifications, but courts do take steps to make sure these are people who have the skills and experience to effectively represent defendants in Federal court.

Senator DURBIN. And one of the things that you refer to in your testimony is a statistical survey of attorneys. And can you tell me what your conclusions were from that survey?

Judge GIBBONS. Well, the surveys showed us that over 50 percent of judges thought that their courts were having difficulties in recruiting attorneys at the then-hourly rate of $90. Thirty-eight percent of the attorneys surveyed said they had declined a case because of the low rate of compensation; 70 percent of the attorneys said an increase would be required for them to accept more cases; and then, most importantly, we learned that, after overhead deductions, the attorneys are actually making about $26 an hour. These same attorneys, if billing to a private-paying client, would be charging an average of $212 an hour. This was in early 2005, when the surveys were done. And so, then, after deduction of overhead, the effective rate for the attorney would be $148 an hour. Those are the primary results of the survey. I've been told by the helpful staff behind me that panel attorneys, on average, have at least 5 years experience.

Senator DURBIN. Now, let me ask you about the universe of those who were surveyed. Are they those who had previously served on panels?

Judge GIBBONS. Yes, they were serving on the panel at the time the survey was done.

Senator DURBIN. And do you know how this $113-an-hour rate was arrived at?

Judge GIBBONS. Well, yes.

It's one of those judgment calls. We believe——

Senator DURBIN. Since you're a judge, that makes sense.

Judge GIBBONS. That seems appropriate. There's a methodology under which we believe calculating inflationary increases that actually we would be entitled to—we could make a case, we thought, for asking up to, I believe it's $133 an hour for fiscal year 2008. However, we felt that, given current budgetary constraints, and given the fact that we were asking for a fairly large jump at one time, we felt that $113 was an appropriate rate to request.

Senator DURBIN. Is the current rate inadequate to attract qualified panel attorneys?

Judge GIBBONS. In some cases, yes.

Senator DURBIN. Thank you.

Senator Allard.

FISCAL YEAR 2008 REQUEST

Senator ALLARD. Thank you, Mr. Chairman.

In the fiscal year 2007 appropriations, they were not enacted until February 15, but you'd been working on your 2008 budget long before that. So, I'm curious, in developing that 2008 request, what funding levels did the judiciary assume for 2007?

Judge GIBBONS. In formulating the 2008 request, we assumed that we would receive the midpoint of the House-passed and Senate-reported bills, less 1 percent for an across-the-board rescission. What we actually got was $44 million less than that.

Senator ALLARD. I see. Okay. And what impact did the 2007 enacted level have on the judiciary's 2008 request?

Judge GIBBONS. Well, we made adjustments to our fiscal year 2008 request based on 2007 enacted levels. In the normal course of things, we would be providing a formal budget re-estimate to you in May. We have gone ahead and revised the 2008 request downward by $80 million. And what's changed since its original submission is $37 million in reduced rental costs as a result of the rent validation efforts. Some judgeship vacancies were not filled that we had assumed would be filled. That reduced our 2008 request by $23 million. The $20 million we got in 2007 for additional staff for our immigration and law enforcement workload, actually enabled us to take out of the 2008 request the $21 million we requested for new staff. And the reason for that is the $20 million translates to about 200 employees, and, because of the nature of the employees we're hiring, we can't bring that many employees onboard that quickly. So, we asked for no new staffing for 2008, and plan to revisit our staffing needs, as far as any upward adjustment, in 2009.

GENERAL SERVICES ADMINISTRATION CONSTRUCTION PROJECTS FOR THE JUDICIARY

Senator ALLARD. Well, thank you, I appreciate your answer on that.

GSA recently sent us a list of projects, including courthouses that it proposes to fund in 2007. Does this list represent the judiciary's priorities?

Judge GIBBONS. Yes, it reflects our 5-year construction plan.

Senator ALLARD. And I'm curious, could you explain the process for scoring and ranking a project and determining the cost?

Judge GIBBONS. Well, the court—the projects that are listed on the 5-year plan are scored in priority order on the basis of criteria that are weighted, in terms of importance. Security concerns count for 30 percent; length of time a building has been filled to capacity, 30 percent; operational problems of existing facilities, 25 percent; number of current and projected judges needing a courtroom, 15 percent. As far as costs are concerned, we use estimates. When we have an estimate from GSA, we use that. Until we have an estimate from GSA, we use our own estimates. And I think that, in very broad terms, describes the process.

Senator ALLARD. Now, sometimes these changes that occur, I understand from—there are some changes that occur from year to year. Why does that happen?

Judge GIBBONS. Well, delays cost money.

Senator ALLARD. I see.

Judge GIBBONS. Sometimes things don't turn out quite as intended. I looked this morning at the 5-year plan, and learned, for example, there was one project where initially GSA intended to use federally owned property. Later, that property didn't become available, and so another site acquisition was required. All kinds of things that can come up in the course of a construction project.

Senator ALLARD. I see.

Mr. Chairman, my time's expired. I have—I'd like to follow up on this, and that would complete my questioning, if I might.

Senator DURBIN. Go ahead.

COLORADO DISTRICT COURT

Senator ALLARD. In Colorado, we're hearing about the need for two district courts. I mean, we've got—one district court covers the whole State. We look at Arkansas. They have two districts in that State, and they don't have a mountain range that runs up and down and divides the State into two distinct geographic areas with problems in transportation, particularly when we've had a winter like we've had this winter. And we also have two population centers. The population center in El Paso County, which is Colorado Springs, is as big as the Denver—the city and county of Denver now; and we have huge growth issues, as far as the State is concerned, 30 percent. And they're not listed on the priority. And I know that when you create a new district, you create a new courthouse. And I wondered if you might comment on our situation in Colorado. We've got some opposition, I think, from the judges that are sitting on the court in Denver, because they like it there, it's a nice, big metropolitan area. In Colorado Springs, we—from law enforcement, we hear a lot of concerns because of having to move prisoners, when there's traffic concerns and problems and security issues, and then, over the mountain, obviously, the truck goes on the pass, gets turned sideways on the road in some way, that creates a problem.

Judge GIBBONS. You know, unless Jim feels that he has enough information to speak to Colorado directly, if we may, I would prefer that we get back to you about that.

Senator ALLARD. I would appreciate that.

Judge GIBBONS. I, obviously, in order to advocate the judiciary's budget, have to know something about construction and how those are processed, but the primary committee within the judiciary that deals with those issues is our Space and Facilities Committee. A representative from that committee, either in talking with you directly or in providing a supplemental answer to the question, would be able to tell you in much more detail how this would be approached, whether anything is actually going on with respect to the Colorado situation, at this time——

Senator ALLARD. I'd appreciate that. Thank you very much.

And thank you, Mr. Chairman, for your indulgence.

Senator DURBIN. Thank you, Senator.

[The information follows:]

The Judicial Conference does not take a position on the creation of a new judicial district unless legislation has been introduced in Congress. The Judiciary is not aware of any legislation that has been introduced in the current or previous Congresses to create a second judicial district in Colorado. When legislation is introduced that creates a new district or a new division within an existing district, the Judicial Conference sends the legislation to the chief judge(s) of the affected district(s) and circuit(s) to evaluate the merits of the legislative proposal based on caseload, judicial administration, geographical, and community-convenience factors. During this evaluation, the views of the affected U.S. Attorney(s) are also considered. Only when the legislative proposal has been approved by both the affected district court(s) and the appropriate circuit judicial council(s) does the Judicial Conference's Committee on Court Administration and Case Management review the proposal and recommend action to the Judicial Conference.

Since legislation has not been introduced, the Judicial Conference has not taken a position on splitting the District of Colorado, although the district court in Colorado does not believe that splitting the district would be cost effective. Doing so would require a new courthouse, clerk of court, bankruptcy court, and probation and pretrial services office. A new district would also significantly impact the U.S. Marshals Service. The federal court caseload in Colorado Springs does not support either a second district for Colorado or the creation of a separate division within the current district. From fiscal year 2004 to fiscal year 2006 criminal felony filings for Colorado Springs/Pueblo declined 29 percent from 95 to 67 filings. Criminal misdemeanor filings handled by a magistrate judge declined by 46 percent, from 307 filings in fiscal year 2004 to 167 filings in fiscal year 2006. Also, the district's probation office is currently reducing its officers in Colorado Springs due to declining caseload.

Colorado Springs, county seat for El Paso County is approximately 65 miles from Denver on Interstate 25, a significant part of which is now three lanes each way. El Paso County is served weekly by a magistrate judge to handle petty offense and misdemeanor matters generated at the numerous military installations in the area (Public Law 108–482, enacted on Dec. 23, 2004, amended Section 85 of title 28, to include Colorado Springs as a place of holding court). The district recognizes and is addressing the need for enhanced magistrate judges presence in Colorado Springs to address civil matters there.

The district court in Colorado is not supportive of a separate district or division based upon the above cost-versus-need considerations. The district's long-range plan approved by the circuit council is now complete with the construction of the Alfred A. Arraj U.S. Courthouse and the Byron Rogers Federal Building and U.S. Courthouse in Denver.

THE COURTS' CASELOAD

Senator ALLARD. I'd like to address this caseload issue, if I might. And the statistics which you have referred to when it comes to staffing indicates a pretty substantial increase in aggregate caseload—195 percent, in fact—between 1984 fiscal year and fiscal year 2006. And yet, in all of the categories of anticipated filings in this fiscal year, with perhaps one exception—appellate filings, civil filings, criminal filings, and bankruptcy filings—you are anticipating

a decline in caseload, the exception being the Southwest area, where caseloads have gone up dramatically on immigration questions. I can see the case you're making for an increased caseload up to 2006, while staffing resources have barely increased. Tell me, as you look forward to 2007, if the argument can't be made that things are starting to level off, in terms of caseload.

Judge GIBBONS. Well, maybe. The reason we included, in the written testimony, the historical chart that goes back to 1984 was to give an illustration of how, although caseload fluctuates, maybe goes up and down in the short term, over time it has trended upward. And that's really just to give you a context within which to consider the current rather modest declines.

Another thing to keep in mind is, these are projections, and so we're always a little bit careful about how we use them. I asked, yesterday, "How do we project what our filings are?" Well, the answer is, "We take our actual filings for 1 year, and we run them through various statistical forecasting models and get, you know, a 3-year projection." I said, "How accurate are they?" And they said, "Well, first year, pretty good; second year, a little less so; third year, a little less so."

So, we don't really know what to make of these modest declines in appellate and district court caseload. We also don't quite know yet exactly what to make of the situation in bankruptcy. It's obvious there's a real drastic decline in cases, but that may not translate into a drastic decline in workload, given the requirements of the new law. And then, of course, we have upward trends in workload, still, in probation and pretrial. So, maybe it's the beginning of some overall trend, but maybe not. I think we'd be hesitant to attach too much future importance to it.

PROBATION AND PRETRIAL SERVICES

Senator DURBIN. And I want to go to the one point you just made. I think the case you make on probation and pretrial services is very compelling, the nature of the work that's being done there, and the importance. It appears that the rate of incarceration has dramatically increased for those who are being served by that part of our system. And, of course, their success can reduce recidivism, which is an added cost to society, first; and taxpayers, second. So, when it comes to the allocation of staff, let's say, for the probation services, where's that decision made?

Judge GIBBONS. Well, we have various work measurement formulas which are our ways of measuring the work. And those are the—those, plus some adjustments for—for example, we done a 2-percent productivity assumption—but those are—figure in to what our budget request is. Then, after we receive our request, we have the ability to make some ad hoc adjustments, depending on, you know, if we've had, say, since the time of the submission of the request, or since the time of our last re-estimate, we've had substantial increases in an area, we'll take that into account and make adjustments in the financial plan, which comes back to you for approval and review, and then in the allotments to the courts.

[The information follows:]

The Judiciary has work measurement formulas that it uses to measure the courts' work in order to determine staffing needs. The allocation of staff and the associated

funding is based on each court units' workload as well as resources available for the courts on a national level. Once Congress provides an appropriation, the Judiciary makes a determination on how best to utilize the funding to cover rent costs, information technology investments, judge and chamber needs, and staffing needs in clerks and probation offices nationwide. The bulk of the Judiciary's costs are for must-pay items over which it has little control. The remaining funds are used for court staffing and operating costs. Workload in a specific court or probation office is the primary cost driver of how staffing allocations are made to each court unit, although funding constraints necessitate that funding for staff be reduced well below the staffing levels indicated as necessary by the staffing formulas.

ADAM WALSH CHILD PROTECTION AND SAFETY ACT

Senator DURBIN. And you make a point here in your testimony about recent legislation, the Adam Walsh Child Protection and Safety Act of 2006, which will increase, significantly, the number of sex offenders coming into the Federal probation and pretrial system for supervision; and monitoring their behavior, you say, is very challenging, requires intense supervision. I will say, and I'm sure it comes as no surprise, that I'm not sure that any Member of Congress even paused to think about that part of the law. We were—obviously felt that we were answering a need to keep our streets safer and our children safer, but never stopping to think what that meant in terms of additional people working in this area. And for those who believe that you can just consistently cut back in the number of people who are working in the Federal Government, they have to understand that sometimes we pay a price that we don't want to pay. Having people who are effective in this area could protect a lot of children and a lot of families.

Judge GIBBONS. I looked at that statute yesterday, and was really quite surprised at the very specific kinds of ways in which it's going to affect probation and pretrial: Longer periods of supervised release, notification requirements, searches of homes of offenders, required electronic monitoring, in some cases, for pretrial releasees, more stringent Bail Reform Act requirements resulting in more detainees—I mean, it's broad and has an impact in many different ways.

Senator DURBIN. And each and every aspect of it is defensible and laudable, and yet, from a practical standpoint, it puts a greater burden on the courts, and one that is more costly to the taxpayers. It is something which we should be more honest about when we talk about these things here in Washington.

REPORTING ON IMPACTS AND RESULTS

The judiciary routinely reports statistical information, but doesn't necessarily take it to the next level by providing the impact or results of the data. For example, Congress mandated, in 1988, that district courts make alternative dispute resolution available to litigants, but there hasn't been a report of accomplishment about which methods of alternative dispute resolution are more likely to settle cases and avoid a trial. Would you consider reporting on the impact of the way the judiciary does its work, beyond simple statistical reporting?

Judge GIBBONS. I gather you're asking for a report, beyond an answer to your question today.

Senator DURBIN. Yes.

Judge GIBBONS. We will report on whatever Congress asks us to report on, Mr. Chairman.

Senator DURBIN. Thank you.

Well, this is one of those congressional mandates which we think is a very compelling thing and is usually ignored by many agencies. So, I hope that you'll take a second look at it and see if you might report to Congress on which methods are most successful.

Judge GIBBONS. I will just make one very general comment. I was a district judge for 19 years before becoming an appellate judge, and had a number of experiences with a number of different kinds of alternative dispute resolution in the district court. And there are a number of them that are very effective. And most courts are quite enthusiastic about implementing them.

[The information follows:]

Staff at the Administrative Office of the U.S. Courts will have further discussions with Subcommittee staff regarding a report on which methods of alternative dispute resolution are most effective.

Senator DURBIN. Thank you very much.

I want to apologize to you and to Mr. Duff, and to all present, for coming in late. That's something that I think is disrespectful, and feel very badly about that. But I thank you for your patience, and especially for your testimony.

ADDITIONAL COMMITTEE QUESTIONS

And we will leave the record open for those who might submit additional questions for you to consider.

I appreciate the benefit of hearing from you about your funding needs for the judiciary. I think we have further insights into your operations, and they'll help us in our deliberations.

As I have mentioned, the hearing record will remain open for a period of 1 week, until Wednesday, March 28, at noon, for subcommittee members to submit statements and/or questions for the record.

[The following questions were not asked at the hearing, but were submitted to the judiciary for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

Question. The Judiciary received an additional $20 million in the fiscal year 2007 continuing resolution to address critically understaffed workload associated with immigration and other law enforcement needs. The funding was provided because the caseload at the Southwest Border courts has reached critical levels, in part, due to forced staffing reductions a few years ago. How do you plan to use these resources?

Answer. The $20 million will enable courts that are critically understaffed to hire about 200 staff to address increased workload needs resulting from immigration and law enforcement initiatives as well as other workload drivers.

The Judiciary's fiscal year 2007 financial plan allots a net additional $5.7 million in salary funding based on the workload needs of the courts as determined by the staffing formulas. Of this amount, $3.3 million (58 percent) was allotted to the five Southwest Border courts to address workload needs. This $3.3 million equates to approximately 65 FTE. The remaining $2.4 million (42 percent) was provided to the remaining appellate and district courts and probation and pretrial services offices to address workload needs.

Since the Judiciary was operating under a continuing resolution until February 15, 2007, courts were instructed to operate at fiscal year 2006 funding levels and to restrict discretionary spending. This meant that only courts that had attrition during the continuing resolution were allowed to hire. Some courts conducted preliminary recruitment activities during this time and are ready to fill vacancies

quickly, while other units have delayed the entire hiring process until final 2007 funding levels were known.

Given the lead time it takes to recruit and hire, all $20 million cannot be obligated during fiscal year 2007. We have therefore set aside in reserve the remaining $14.3 million (the $20 million less $5.7 million for new staff in the 2007 plan) so that funding will be available in fiscal year 2008 for courts to continue to fill these positions.

Question. The Judiciary's revised fiscal year 2008 budget request this year calls for a 7.6 percent increase, an amount likely to be more than the Subcommittee will be able to provide. What are you doing to make yourself more efficient in order to accommodate lower resource levels?

Answer. While the Judiciary requires a 7.6 percent overall increase to fund fully its request, it requires a 6.5 percent increase just to maintain a current services level of operations.

Actions That Reduced Fiscal Year 2008 Appropriations Requirements

The Judiciary has taken several actions to become more efficient and to limit fiscal year 2008 appropriations requirements in the Salaries and Expenses account. These actions reduced the fiscal year 2008 appropriation requirements for the Salaries and Expenses account by $80 million. These actions include:

—Applying a productivity factor to the staffing formulas to reflect the enhanced productivity achieved through the use of improved business processes and the use of technology (−$15 million, −199 FTE).

—Implementing cost containment initiatives in probation and pretrial services offices (−$28 million, −322 FTE).

—Reviewing and validating GSA rent bills to ensure that GSA is applying its space pricing policies accurately ($37 million).

Space Initiatives

The Judicial Conference continues to build on its cost-containment strategy that was adopted in September 2004. The Judiciary is establishing budget caps in selected program areas in the form of maximum percentage increases for annual program growth. For our space and facilities program, the Judicial Conference approved in September 2006 a cap of 4.9 percent on the average annual rate of growth for GSA rent requirements for fiscal years 2009 through 2016. By comparison, the increase in GSA rent in our fiscal year 2005 budget request was 6.6 percent. This cap will produce a GSA rent cost avoidance by limiting the annual amount of funding available for space rental costs, and courts will have to further prioritize space needs and deny some requests for additional space.

An interim budget check process on all pending space requests was implemented in order to slow space growth. The budget check ensures that circuit judicial councils, together with the Administrative Office, consider alternative space, future rent implications, and the affordability of any request by the Judiciary. This approach is helping to control the growth in costs associated with space rent for new courthouses and major renovations.

The Judiciary completed a comprehensive review of the U.S. Courts Design Guide. In March 2006, the Judicial Conference endorsed revisions to the U.S. Courts Design Guide that lower the future rental costs of chambers space by reducing the size of the judge's office in non-residential chambers and chambers' conference rooms, and reducing the number of book shelving ranges and chambers' closets. The standards of the revised Design Guide will apply to the design and construction of new buildings and annexes, all new leased space, and repair and alteration projects where new space, including courtrooms and chambers, is being configured for an entire court unit.

The Judiciary's rent validation project has achieved significant savings. This initiative originated in our New York courts where staff spent months scrutinizing GSA rent bills and found rent overcharges. The cumulative effect of this discovery was savings and cost avoidance over three fiscal years totaling $30 million. The Administrative Office expanded this effort nationwide by training all circuit executive offices to research and detect errors in GSA rent billings. Although it is quite time consuming, detailed reviews of GSA rent billings are now a standard business practice throughout the courts. Through the rent validation effort the Judiciary recently identified additional overcharges totaling $22.5 million in savings and cost avoidance over three years. GSA has been very responsive to correcting billing errors that we bring to their attention. By identifying and correcting space rent overcharges we are able to re-direct these savings to other Judiciary requirements, thereby reducing our request for appropriated funds.

Information Technology Initiatives

The Judiciary is at the forefront of the federal government's efforts to leverage the use of information technology to automate business processes and maximize efficiency. For example, the Judiciary's Case Management/Electronic Case Filing (CM/ECF) project automates the paper intensive case filing process. The Judiciary's CM/ECF system is operational in all bankruptcy courts, 92 district courts, one appellate court, the Court of International Trade and the Court of Federal Claims. Implementation is underway in all remaining courts. The Judiciary anticipates long-term efficiencies will be achieved as a result of the CM/ECF implementation. This benefits not only the Judiciary, but also the bar and public who will have greater access to court information.

At least 80 percent of all bankruptcy cases are being filed electronically by attorneys in about 80 percent of the bankruptcy courts, and in many bankruptcy courts nearly all of the cases are being filed electronically. In addition, the courts have been enhancing efficiency through a combination of local management initiatives and court-developed automation innovations. For years, the bankruptcy clerks have been adopting new management techniques, developing and sharing best practices, and using the flexibility provided under the Judiciary's budget decentralization program to invest in automation solutions that save resources as well as improve quality and performance.

In our probation and pretrial services program, the Probation Automated Case Tracking System (PACTS) electronic case management system makes probation and pretrial services officers more efficient by enabling them to access from their workstations a wide range of case-related information. In fiscal year 2007, the Judiciary will complete consolidation of PACTS servers from all 94 districts into two contractor-owned and operated facilities. The consolidation will help the Judiciary avoid $3 million in costs over the next five years, with no degradation in service. Further, consolidating servers provides two levels of fail-over capabilities, a feature that did not exist in the old decentralized system of district-based servers, thereby providing extraordinary value in terms of continuity of operations planning. Probation and pretrial services offices continue to automate segments of their business processes to improve service to the court, other law enforcement and criminal justice agencies, and the community. Enhancements to the PACTS will continue in fiscal year 2008 to help offices manage cases more efficiently.

Question. The fiscal year 2008 request for Defenders represents an $84 million or 11 percent increase over last year and the fiscal year 2007 appropriation level helped address the needs of Defenders. Why is this level of increase still needed?

Answer. In fiscal year 2008, the requested $83.6 million increase in appropriations consists of the following categories:

	Amount of Total Increase	Percent Increase	Percent of Total Increase
Pay/benefit adjustments and standard inflationary increases	$29,685,000	3.8	35.5
Additional 8,200 representations	21,960,000	2.8	26.3
Replace fiscal year 2006 carryforward	9,509,000	1.2	11.4
Subtotal, Adjustments to Base	61,154,000	7.9	73.2
Increase in panel attorney rates from $96 to $113 per hour	21,797,000	2.8	26.1
Establishment of two new FDOs	600,000	0.1	0.7
Subtotal, Program Increases	22,397,000	2.9	26.8
Total Increase	83,551,000	10.8	100.0

Although the Defender Services' fiscal year 2008 request of $859.8 million represents an $83.6 million (10.8 percent) increase in appropriations, a $61.2 million (7.9 percent) increase is required in this account just to maintain current services which includes funding for standard pay and non-pay inflationary increases and funding for 8,200 additional Criminal Justice Act representations projected for fiscal year 2008. The remaining $22.4 million (2.9 percent) is requested for program increases to (1) increase the non-capital panel attorney rate from $96 to $113 per hour ($21.8 million)—substantially less than the $133 hourly rate panel attorneys would receive had COLAs been funded every year since 1986; and (2) establish two new federal defender organizations ($0.6 million).

Question. The Judiciary has commented in recent years on the inadequacy of court staffing levels, given the courts' workload growth over the last several years.

In applying budget balancing reductions each year, what priority does the Judiciary give to funding court staff salaries versus other program priorities (information technology, space rent, operating costs, etc.)?

Answer. The Salaries and Expenses (S&E) financial plan is divided into four main categories: (1) mandatory, (2) historically fully funded, (3) short-term uncontrollable, and (4) controllable. The first three spending categories are funded fully in the development of the financial plan. For formulation and long-range planning purposes, all funding categories are subject to scrutiny and cost-containment initiatives.

The first three categories include funding for judges and chambers staff salaries and benefits, court staff benefits, funding for law enforcement activities and contracts including drug testing and treatment, mental health treatment and electronic monitoring, law books, GSA space rental, background investigations, law enforcement training, and long distance telephone charges.

All budget balancing reductions are applied to the fourth spending category, the controllable portion of the budget which includes items such as court staff salaries, court operating expenses, information technology, and national training programs. Budget balancing-reductions reflect the views, input, and in some instances, specific recommendations from various Judicial Conference committees and court advisory groups. Once funds are allotted to the courts, funding priorities are determined at the local level in accordance with the Judiciary's budget decentralization policies.

Court salaries comprise about 32 percent of the Salaries and Expenses total budget and over 80 percent of the controllable spending category. The formulas used to calculate staffing and salary needs are scientifically-derived and incorporate the functions and work requirements of the different court programs. Of the controllable items, court staff salaries receive the highest priority.

To balance requirements with available resources, the Judiciary has traditionally applied a lower percentage reduction to court salary allotments. In years in which the Judiciary has received severe funding reductions, the percent reduction applied to the non-salary accounts has been up to three times the reduction applied to court salaries. The fiscal year 2007 financial plan reflects a 5.9 percent reduction to court salary allotments, and a 12 percent reduction to court operating expenses from full requirements.

Question. In studying how you formulate your budget, the National Academy of Public Administration (NAPA) recently recommended that you work with Executive Branch agencies such as Justice and Homeland Security more closely to determine the impact of their operations on the Judiciary. This would appear to be a good idea and might have helped you last year when the Administration did not include needs for the Judiciary in its Southwest Border Initiative package for consideration in the fiscal year 2006 Supplemental Appropriations bill last year. What is your opinion on this recommendation?

Answer. The Judiciary has received a draft copy of the study and is in the process of preparing agency comments. Comments will be provided to NAPA for its consideration in finalizing the report.

Page 37 of the draft NAPA report states the following:

"A strategic, comprehensive approach to budgeting is further hampered by the constitutional separation of powers between the judicial and executive branches. The absence of communication or integrated deliberations about budgets for all parts of the justice system make it more likely that budgets for the executive and judicial branches will not address reciprocal workload implications. Such disconnects can reduce the overall effectiveness of the justice system and can, in extreme cases, produce bottlenecks or disruptions that threaten the fair and full administration of justice. The Panel realizes that this is something over which the Judiciary has no control. It is not a practice within OMB or among congressional appropriations committees to ensure that actions in one part of the federal budget do not have an impact on another. Assembling and considering a federal budget is complex and can consume those involved with broad issues and program details; it is enough to deal with their portion of it. However, as the entity at the final end of the 'decision continuum,' the Judiciary may have the most incentive to urge the branches to consider better ways to assess the impact of the proposed policies and spending decisions."

As the excerpt above notes, the Judiciary is at the tail end of the "decision continuum." Although the draft report indicates the Judiciary may have the most to gain in urging the three branches to work cooperatively to assess the impact of polices and spending decisions on the other, the Judiciary is powerless to effect change unilaterally. The Judiciary welcomes opportunities to work more closely with Executive Branch agencies on policies and initiatives that impact the federal courts.

Question. Strategic planning has become a valuable tool to Executive Branch agencies as they plan for the future. Why doesn't the Judiciary use strategic planning?

Answer. The Judicial Branch has engaged in strategic planning for many years. The Judiciary's role in our constitutional system and its unique governance structure necessitate different planning approaches than used in the Executive Branch, but its planning efforts are nonetheless serious and meaningful. Indeed, the Judiciary has successfully incorporated strategic planning into the fabric of its policy-making processes.

The Judiciary developed two strategic planning documents in the 1990's that remain valid. They are supplemented, as described below, with ongoing long-range planning activities that identify and address emerging strategic issues. The plans followed an extensive process that involved reaching out within the Judiciary and to other branches of government, the bar, and the public. Chief Justice William H. Rehnquist appointed a Long-Range Planning Committee of the Judicial Conference to coordinate this activity. The resulting Long-Range Plan for the Federal Courts identified the Judiciary's mission, core values and strategic concerns. It articulated a vision to guide the federal courts in fulfilling the role the Constitution and Congress assign to them, and it was intended to be relevant for the foreseeable future and serve as the underlying framework for planning, policy-making, and administrative decisions. That plan was closely followed with The Administration of Justice: A Strategic Business Plan for the Federal Courts, which articulated broad goals and objectives.

The Judiciary's national policy-making body is the Judicial Conference of the United States. The Judicial Conference's strategic planning process is coordinated by its Executive Committee and involves committees of the Judicial Conference and the Administrative Office of the U.S. Courts. Through its planning process the Judiciary identifies strategic issues and ensures long-term implications are considered in assessing Judiciary operations and programs; analyzing trends and developments; identifying ways to improve efficiency, effectiveness, and economy; and developing policies. The strategic planning process has enabled the Judicial Branch to anticipate, react and adapt to events and changes in a manner that conserves and enhances its core values.

The Judicial Conference's Executive Committee coordinates long-range planning efforts across committees, including the identification of crosscutting strategic issues. The Executive Committee meets with the chairs of committees twice each year to discuss Judiciary planning matters. One member of the Executive Committee serves as long-range planning coordinator. The process is supported by the Administrative Office's long-range planning office, in existence since 1991.

The long-range planning meetings of committee chairs provide an effective forum to discuss Judiciary-wide planning issues such as long-range projections of caseload and resources, funding constraints, workforce trends, changes in programs and operations, and the impact of technology. The various committees also engage in strategic planning within their areas of responsibility. They identify strategic issues, analyze trends, undertake studies, seek input, and consider alternative approaches before making policy recommendations to the Judicial Conference.

This active planning process enables the Judiciary to identify and address matters of strategic importance. For example, the consideration of workload and budget projections, in conjunction with anticipated funding constraints, highlighted the need for a long-term strategy to control the rates of growth in the Judiciary's future costs. An intensive effort was launched to assess the situation, and it resulted in the development of a cost-containment strategy for the Federal Judiciary.

The committees' planning efforts have been conducted in a manner best suited to their areas of responsibility. For example, administrative aspects of the Judiciary's business are more conducive to the development of specific plans of action, such as determining what technology projects will be pursued. The Committee on Information Technology produces a Long Range Plan for Information Technology in the Federal Judiciary, which is provided to Congress.

Question. The Judiciary does not regularly publish stated goals that you are then held to. Why not? How do you expect us to be informed of how accurately you use your resources without such information?

Answer. The goals of the Judiciary reflect the responsibilities that the Constitution and the Congress have assigned to the Third Branch. Based on the mission and core values set forth in the Long Range Plan for the Federal Courts, six fundamental goals are defined in The Administration of Justice: A Strategic Business Plan for the Federal Judiciary: to safeguard the rule of law; to guarantee equal justice; to preserve judicial independence; to sustain our system of federalism with na-

tional courts of limited jurisdiction; to maintain excellence; and to ensure accountability.

These goals do not change from year to year. The Judiciary's role is to handle the cases that come before the courts in a manner that is consistent with the fundamental values expressed in these goals. The Constitution vests the federal courts with the Judicial Power of the United States and the federal courts' business is defined by others. Congress determines the scope of federal jurisdiction, the structure of the Judiciary, places of holding court, and the number of judgeships. Litigants bring cases to the courts, and the Executive Branch is a primary litigant in the federal courts. Simply stated, the courts render decisions on matters that are brought to them; they do not determine what those matters will be, when they will come, how many will come, or who will bring them.

The Judiciary's resource needs are linked to the courts' caseload, the number of judicial districts and places of holding court, and related workload measures. Initiatives of importance undertaken by the Judiciary are reported to Congress in the Judiciary's budget as well as through annual reports and reports of the proceedings of the Judicial Conference.

Funding is provided to the courts through established national formulas based on workload factors, and the Judiciary reports extensively on its work. Many reports are produced, but of particular importance are reports on Judicial Business of the United States Courts and Federal Court Management Statistics, published annually by the Director of the Administrative Office of the U.S. Courts. These comprehensive reports contain details on national and court-specific statistics and comparative indicators. They cover cases filed, terminated, and pending; disposition actions; actions per judgeship; median time to (case) disposition; activities and actions on cases; probation and pretrial services work; defender services work, and many other facts. Semi-annual reports prepared pursuant to the Civil Justice Reform Act of 1990 provide data on motions pending for more than six months, bench trials submitted for more than six months, bankruptcy appeals and social security appeal cases pending more than six months, and civil cases pending more than three years. Juror utilization data are published each year. The United States Sentencing Commission collects records on each criminal sentence and reports on the courts' sentencing actions. Also, specialized reports on particular topics are frequently produced by the Judiciary, including reports requested by Congress.

In summary, accountability is a core value of the Judiciary. Its proceedings and records are open to the public, and an array of reports provides a broad and deep accounting of the work performed by the Judiciary with the resources provided.

Question. The new bankruptcy legislation took effect in October 2005, and it appears that filings have not yet rebounded. What filing patterns do you expect will emerge over the longer term?

Answer. Over 600,000 petitions were filed in October 2005, most of them just prior to the implementation date, October 17, 2005, of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Immediately following October 17, the number of new petitions plummeted—14,000 cases were filed in November 2005. Monthly filings have since been rising.

Historically, bankruptcy filings have exhibited strong seasonal patterns—with filings increasing during the early spring and declining during the late fall and early winter. Following October 17, 2005, the normal seasonal patterns were disrupted. Recent data, however, indicates that the seasonal patterns are reasserting themselves, evidenced by the 74,000 bankruptcy filings recorded for March 2007, a new post-BAPCPA high. This may suggest a return to historical filing patterns.

No consensus exists regarding the long-term effect of BAPCPA on overall filings. Some bankruptcy experts believe that the long-term effect will be minimal; others substantial. Most agree that the more work intensive chapter 13 filings will become more prominent.

Question. What has been the impact on the courts' workload as a result of the Booker/Fanfan Supreme Court decisions? Have all of the cases that came into the system been dispensed with?

Answer. The Supreme Court's decisions in *Blakely* v. *Washington*, 542 U.S. 296 (2004) (*Blakely*) and *United States* v. *Booker*, 543 U.S. 220 (2005) (*Booker*), affected filings in the appeals and district courts as the Judiciary reported in a June 2006 report requested by the House and Senate Appropriations Committees. This impact began when *Blakely* was decided in June 2004. Since then, in the courts of appeals, over 13,700 appeals resulting from *Blakely* and *Booker* were filed. During the same time, in the district courts, over 6,000 *Booker*-related habeas corpus petitions were filed by prisoners sentenced in the federal courts, about the number of such motions district courts receive each year. By the one-year anniversary of *Booker* in January 2006, all habeas corpus motions by prisoners who were eligible to file when *Booker*

was decided had been filed. By September 2006, the numbers for the filings of these motions had returned to their levels prior to *Booker*. To date, appeals and district courts have processed large numbers of such motions. However, their pending caseload remains high so all of the cases that came into the system have not been dispensed with.

Since January 2006, fewer criminal appeals have been filed than during the first year after *Booker*. However, the current numbers continue to be at levels 29 percent above what they had been before *Booker*. This leads the Judiciary to conclude that the criminal appeals caseload after *Booker* will remain at a level higher than it was before *Booker*, just as the criminal appeals caseload rose permanently to a new level after the U.S. Sentencing Guidelines were created.

In addition, *Booker*-related filings in the appeals and district courts are taking longer to resolve. This has increased the median disposition times for criminal appeals by two months, and for appellate prisoner petitions and district court criminal cases by one month. This explains why the *Booker*-related pending caseload remains high despite the increase in the number of such cases resolved.

Question. Please provide a brief summary of the Judiciary's cost-containment efforts.

Answer. In fiscal year 2004, the Judiciary received a significant reduction to its budget request, primarily due to across-the-board cuts applied during final conference on our appropriations bill. This funding shortfall resulted in staff reductions of 1,350 employees, equal to 6 percent of the courts' on-board workforce. Of that number, 328 employees were fired, 358 employees accepted buyouts or early retirements, and 664 employees left through normal attrition and were not replaced.

The 2004 situation made clear that the Judicial Conference had to take steps to contain costs in a way that would protect the judicial process and ensure that budget cuts would not harm the administration of justice. In March 2004, the late Chief Justice William H. Rehnquist charged the Judicial Conference's Executive Committee with leading a review of the policies, practices, operating procedures, and customs that have the greatest impact on the Judiciary's costs, and with developing an integrated strategy for controlling costs. After a rigorous six-month review by the Judicial Conference's various program committees, the Executive Committee prepared, and the Judicial Conference endorsed, a cost-containment strategy. The strategy focused on the primary cost drivers of the Judiciary's budget, which included an examination of the number of staff working in the courts, the amount they are paid, and the rent paid to the General Services Administration for courthouses and leased office space. Pursuing the implementation of cost containment initiatives is a top priority of the Judicial Conference.

Question. Does the fiscal year 2008 request reflect any reductions associated with cost-containment?

Answer. The Judiciary has taken several actions to become more efficient and to limit fiscal year 2008 appropriations requirements in the Salaries and Expenses account. These actions reduced the fiscal year 2008 appropriation requirements for the Salaries and Expenses account by $80 million. These actions include: (1) applying a productivity factor to the staffing formulas to reflect the enhanced productivity achieved through the use of improved business processes and the use of technology (−$15 million, −199 FTE), (2) implementing cost containment initiatives in probation and pretrial services offices (−$28 million, −322 FTE), and (3) reviewing and validating GSA rent bills to ensure that GSA is applying its space pricing policies accurately (−$37 million).

Question. What future savings/reductions does the Judiciary anticipate?

Answer. Pursuing the implementation of cost containment initiatives is a top priority of the Judicial Conference. The Judiciary has implemented cost containment initiatives that have already yielded significant savings. Future savings are expected to be achieved through continuing to control space costs; aggregating information technology servers in contrast to the current decentralized deployment scheme; shaping a more focused, cost efficient court support staff through process redesign; evaluating compensation policies with an emphasis on cost containment, and sharing administrative functions in the courts to create efficiencies and reduce operating costs.

Question. As a cost-containment measure the Judicial Conference authorized a two-year moratorium on courthouse construction projects and major renovation projects while the Judiciary re-examined its long-range space planning and design standards. Please summarize the results of your re-examination.

Answer. In March 2006, the Judicial Conference approved, in concept, a new long-range planning methodology for the Judiciary called "Asset Management Planning." The major features of asset management planning include: developing a more comprehensive assessment and documentation of the requested new courthouse and how

it would meet the operation needs of the court; identifying space alternatives and strategies, including minor and major renovation projects as opposed to constructing a new courthouse to meet current deficiencies and future growth needs; the development of a preliminary estimate of the costs to the Judiciary for the project, including additional rent; and developing a cost-benefit analysis to help identify the plan that best meets the short- and long-term needs of the Judiciary.

In addition, over the last two years the Judicial Conference has endorsed multiple amendments to the U.S. Courts Design Guide, that sets forth the space standards for new courthouse and renovation projects. These changes included decreases in the size of chambers suites for all types of judges, public space, atriums and staff offices, and technical amendments to save money.

Question. The Judiciary's rental payments to GSA have increased from $133 million in fiscal year 1986 to more than $1 billion in fiscal year 2008, equal to one-fifth of the courts' spending for salaries and expenses. What is the cause for this increase and what is the Judiciary doing to control these costs?

Answer. The increase in rental costs is caused partially by growth in the amount of space occupied by the Judiciary, but also by growth in the rental rates assessed by GSA. According to GSA, since 1985, the Judiciary has undergone growth of 166 percent in terms of the amount of space occupied, but the growth in court rental costs over the same time period has been 585 percent or 3.5 times the rate of increase in the amount of space. The biggest cost driver, then, has been the growth in rental rates—a consequence of GSA's "market" pricing approach.

The Judicial Conference has approved a cap of 4.9 percent on the average annual rate of growth for GSA rent requirements for fiscal years 2009 through 2016. By comparison, the increase in GSA rent in the fiscal year 2005 budget request was 6.6 percent. This cap will produce a GSA rent cost avoidance by limiting the annual amount of funding available for space rental costs, and courts will have to further prioritize space needs and deny some requests for additional space.

An interim budget check process on all pending space requests was implemented in order to slow space growth. The budget check ensures that circuit judicial councils, together with the Administrative Office, consider alternative space, future rent implications, and the affordability of any request by the Judiciary. This approach is helping to control the growth in costs associated with space rent for new courthouses and major renovations.

The Judiciary completed a comprehensive review of the U.S. Courts Design Guide. In March 2006, the Judicial Conference endorsed revisions to the U.S. Courts Design Guide that lower the future rental costs of chambers space by reducing the size of the judge's office in non-residential chambers and chambers' conference rooms, and reducing the number of book shelving ranges and chambers' closets. The standards of the revised Design Guide will apply to the design and construction of new buildings and annexes, all new leased space, and repair and alteration projects where new space, including courtrooms and chambers, is being configured for an entire court unit.

The Judiciary's rent validation project has achieved significant savings. This initiative originated in the New York courts where staff spent months scrutinizing GSA rent bills and found rent overcharges. The cumulative effect of this discovery was savings and cost avoidance over three fiscal years totaling $30 million. The Administrative Office expanded this effort nationwide by training all circuit executive offices to research and detect errors in GSA rent billings. Although it is quite time consuming, detailed reviews of GSA rent billings are now a standard business practice throughout the courts. Through the rent validation effort the Judiciary recently identified additional overcharges totaling $22.5 million in savings and cost avoidance over three years. GSA has been very responsive to correcting billing errors that are brought to their attention. By identifying and correcting space rent overcharges the Judiciary is able to re-direct these savings to other Judiciary requirements, thereby reducing the request for appropriated funds.

Question. Enactment of bankruptcy legislation and the subsequent decline in filings have reduced fee revenues that the various parties in the bankruptcy system rely on to fund operations. Would you please comment on the impact this decline has had on the Judiciary, as well as the proposals of the case trustees and U.S. Trustees to generate additional fee revenue?

Answer.

Impact on the Judiciary

Filing fee revenue has historically comprised 5 percent of total financing for the Salaries and Expenses financial plan, with 75 percent of all fee collections coming from bankruptcy filing fees. In contrast, filing fee revenue in fiscal year 2007 comprises 3 percent of total financing, with 60 percent of all fee collections coming from

bankruptcy filing fees. The table below displays bankruptcy filing fees from fiscal year 2004 to fiscal year 2008. A significant drop-off in fee revenue is evident beginning in fiscal year 2006 (the bankruptcy reform legislation went into effect at the beginning of fiscal year 2006, on October 17, 2005. The impact of declining fee revenue is that the Judiciary is forced to request additional appropriations from Congress in order to fund current services requirements.

[In thousands of dollars]

	Fiscal Year—				
	2004 Actual	2005 Actual	2006 Actual	2007 Projected	2008 Projected
Bankruptcy Fees	220,759	236,537	168,287	85,532	91,522
Yr-Yr. Change	.....	15,778	(68,250)	(82,755)	5,990

In addition to the reduced number of bankruptcy filings, the change in case mix between Chapter 7 filings and Chapter 13 filings may also be a cause of reduced fee revenue. Prior to the bankruptcy reform legislation, bankruptcy filings were comprised of 70 percent Chapter 7 filings and 30 percent Chapter 13 filings. The current mix is approximately 55 percent Chapter 7 and 45 percent Chapter 13s. The change in case mix will likely result in a reduction in fee collections over the short-term, since various motion-related fees under Chapter 13 may be collected over a period of up to 5 years, versus 90 days for Chapter 7 filings.

Department of Justice Proposals to Increase U.S. Trustee Fees

In its fiscal year 2008 Budget Request, the Department of Justice included two proposals relating to the United States Trustee program. The first would amend Section 589(a) of title 28, United States Code, to designate the deposit of fines collected from bankruptcy petition preparers pursuant to BAPCPA. This provision would have no impact on the Judiciary.

The second proposal, amending Section 1930(a) of Title 28, would increase the quarterly fees collected by the U.S. Trustee in Chapter 11 cases. These fees are paid by debtors directly to the United States Trustee program, based upon the debtor's quarterly disbursements. This proposal would affect the Judiciary in that parallel Chapter 11 quarterly fees are also collected in the six bankruptcy administrator districts in Alabama and North Carolina. The Judiciary would most likely increase quarterly fees in those districts, parallel to the increases proposed by the Department of Justice to the U.S. trustee quarterly Chapter 11 fee increases, to maintain national parity between the two programs. Such fees are deposited as offsetting receipts to the fund established under section 1931 of title 28, United States Code. Aside from a parallel increase in the Chapter 11 quarterly fee in the bankruptcy administrator districts, this proposal would not affect the Judiciary.

Chapter 7 Case Trustee Compensation

For several years, the National Association of Bankruptcy Trustees (NABT) has sought increased compensation for Chapter 7 case trustees. Chapter 7 case trustees are paid $60 per case from a portion of the debtors' filing fee. The Chapter 7 case trustee's compensation is paid over to the trustee by the court if the debtor pays the full filing fee. The Judiciary merely acts as a pass-through for the fees paid by the debtor to the Chapter 7 trustee. The Judiciary has no responsibility to pay the Chapter 7 trustee's fees if the debtor does not pay a filing fee. Additionally, Chapter 7 trustees receive a percentage of distributions made in asset-Chapter 7 cases. Asset Chapter 7 case distributions made by the case trustee are reviewed and approved by the bankruptcy court.

Under the provisions of bankruptcy reform legislation, if a Chapter 7 debtor is granted in forma pauperis status, the debtor does not pay a filing fee. In this circumstance, none of the entities that usually receive a portion of the filing fee (Judiciary, case trustee, U.S. trustee fund and U.S. Treasury) receive any funds.

One NABT proposal is to increase the case trustees' statutory per case compensation from $60 to $100. The case trustees are also seeking a way to receive payments in in forma pauperis cases. The Judicial Conference and the Judiciary have no position on the amount of money Congress determines the case trustees should be paid by the debtors. The only concern of the Judiciary is that the proposals should not impact the amount of fee revenue the Judiciary receives.

Based upon the efforts of NABT, this proposal was included in the House version of the Financial Netting Improvements Act of 2006 ("Contracts Netting Act"). However, it was stripped from the bill in the Senate before the ultimate enactment of the legislation as Public Law 109–390. The case trustee fee increase included in the

House version of the Contracts Netting Act would also have streamlined the collection of fees for processing of payments to case trustees, thus reducing an administrative burden in bankruptcy clerks' offices.

NABT continues to pursue various proposals to enhance Chapter 7 bankruptcy trustees' compensation.

QUESTIONS SUBMITTED BY SENATOR FRANK R. LAUTENBERG

Question. Judge Gibbons, in your experience, do current judicial pay levels pose a threat to the independence and success of the federal judiciary?

Answer. I believe Chief Justice Roberts was correct when he stated in his 2006 Year-End Report on the Judiciary that judicial pay levels pose a threat to the independence of the federal judiciary.

In the past, a federal judgeship was viewed as a capstone to a legal career. As the Chief Justice noted, judges have been leaving the federal bench in increasing numbers. In the past six years 38 judges have left the federal bench, including 17 in the last two years. While this may not represent a mass exodus, it reflects a disturbing trend nonetheless. To the extent that judges are leaving the bench for more lucrative paying jobs then, yes, pay levels do pose a threat to retaining talented, experienced judges. Low pay levels also discourage some well-qualified candidates from seeking and accepting appointment to the federal bench. The strength of our Judiciary is largely determined by the quality of our judicial officers, so the unattractiveness of federal judicial pay is a concern.

Pay erosion is also affecting diversity on the bench. If only the extremely wealthy can afford to accept an appointment, or only those who are appointed from within government service, we will lose diversity on the federal bench.

The Framers of our Constitution saw judicial independence as linked to life tenure. Time has verified their wisdom. Federal judges have historically been scrupulous about adhering to the rule of law and excluding extraneous and inappropriate factors from their decision-making. Chronically low pay levels threaten to create a Judiciary in which judges worry about what their next job will be and whether litigants will be in a position to affect their future careers, which would jeopardize judicial independence and public confidence in an independent Judiciary. This would be a Judiciary far different from that envisioned by the Framers and one with fewer institutional protections against inappropriate influences. I do not believe that it is desirable to test our constitutional system by paying judges inadequately.

Question. In its 1995 Long Range Plan for the Federal Courts, the Judicial Conference recommended giving credit toward retirement benefits for years served as bankruptcy and magistrate judges when such judges are elevated to the Article III bench. Do you believe that bankruptcy and magistrate judges' current inability to receive retirement credits is a disincentive for qualified, experienced bankruptcy and magistrate judges to seek promotion to the District Court?

Answer. It could possibly be a disincentive for bankruptcy judges and magistrate judges to seek Article III judgeships because the years they served in those positions would not be credited towards meeting Article III retirement eligibility. Article III judges must satisfy the "rule of 80," that is, pursuant to 28 U.S.C. § 371(a), (b) and (c), an Article III judge may not retire from office or take senior status until the judge reaches age 65 with a minimum of 15 years of Article III service.

Bankruptcy judges and magistrate judges are not required to satisfy the "rule of 80" provision. Therefore, depending on the age of the bankruptcy judge or magistrate judge, he/she may be able to retire earlier if he/she remains in that capacity. Under the Judicial Retirement System (JRS), a bankruptcy or magistrate judge can retire on an annuity after eight years of service, payable at age 65. For example, a bankruptcy judge or magistrate judge appointed at age 50 will have vested in a JRS annuity at age 58 equal to 8/14 (57 percent) of the salary of the office (payable at age 65); and that same judge would receive a full salary JRS retirement at 65. If that same judge were elevated to an Article III judgeship at age 58, he or she would not be entitled to an Article III "rule of 80" retirement until age 69 when the age and years of service total at least 80. If that judge were allowed to receive credit for his or her 8 years of bankruptcy judge or magistrate judge service, that judge would be entitled to "rule of 80" retirement at age 65 instead of 69.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. Your revised fiscal year 2008 budget submission does not request resources for additional staff. Do you feel that you currently have the appropriate number of staff to address your workload?

Answer. No, the Judiciary does not have the appropriate number of staff to address current workload. The steady workload growth in recent years has not been matched with the staffing resources needed to keep up with that workload. Between fiscal years 2001 and 2006 the courts' aggregate caseload increased by 23 percent while staffing resources increased by only 1 percent.

The Judiciary's staffing formulas indicate that an additional 2,000 staff are required in order for clerks and probation offices to be staffed fully. However, because of the late enactment of appropriations and uncertainty about whether funding will be available in the subsequent year to pay newly hired staff, court managers have been reluctant to hire. This also contributes to the widening gap between workload and staffing resources. The Judiciary has sought to narrow the gap between staffing levels and workload through the implementation of automation and technology initiatives, improved business practices, and cost-containment efforts, but has not been able to close it entirely.

The $20 million provided in fiscal year 2007 will enable the courts to hire about 200 new staff to meet workload demands. However, because full-year fiscal year 2007 funding was not made available to the courts until six months into the fiscal year, and given the lead time it takes to recruit and hire, all $20 million cannot be obligated during fiscal year 2007. We have therefore set aside in reserve the remaining $14.3 million (the $20 million less $5.7 million for new staff in the 2007 plan) so that funding will be available in fiscal year 2008 for courts to continue to fill these positions.

The fact that the courts' workload has begun to stabilize provides the Judiciary an opportunity to use this funding to partially close the gap between current staffing levels and workload.

Question. Given the reduced bankruptcy filing levels over the past 18 months, why does the 2008 Budget Request not reflect a staffing reduction in bankruptcy courts?

Answer.

Workload Per Case Is Increasing

Although bankruptcy filings are down, by virtue of the law's design, case management under Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005 is more complex and time consuming. Court staff are needed to ensure that new requirements mandated by the law to weed out fraudulent debtors and improve the bankruptcy process are being met. Preliminary data from a sampling of courts indicates that per-case work has increased significantly under the new law. Such work not only reflects case management activity related to new requirements, such as means testing for Chapter 7 eligibility, but also to an increased number of motions, orders, and noticing requirements.

Despite the drop in filings, bankruptcy court staff continue to make more than one million docket entries per month and provide quality control checks for one million additional entries generated electronically by attorneys. These figures reflect the results of an initial court sampling of data regarding workload. That data indicates that, under BAPCPA, the number of motions filed per case has increased by 59 percent; more specifically, motions for relief from stay has increased by 73 percent; court orders, by 35 percent, and Chapter 13 cases, the most work intensive cases, by 50 percent.

Pending more definitive information, regarding both filing projections as well as workload analyses, the Judiciary must proceed cautiously to ensure that it protects the needs of the bench, bar, and public. Downsizing of the magnitude that could be required in the bankruptcy clerks' offices could be expensive to conduct as well as disruptive to court services. Once separated, those staff (and their highly specialized electronic case management skills) would not be easily replaced to meet any future upturn in filings. The Judiciary would not only lose its personnel training investment, it would also incur huge severance pay requirements. In the mean time, the courts would not be in a position to address an upswing in filings, especially given the extra work required to carry out the mandates of the law.

Future Filing Trends Still Uncertain

Eighteen months after implementation of the BAPCPA of 2005, experts still cannot agree on its future impact. Bankruptcy filings for March 2007 were 74,000, the highest since the bankruptcy reform legislation went into effect in October 2005 although based on historical trends March is typically a high filing month.

The Judiciary also recognizes that the root causes of bankruptcy—job loss, business failure, medical bills, credit problems, and divorce—were not affected by the law and are expected to continue to be the primary drivers of caseload. Moreover,

economic reports continue to advise that leading indicators of bankruptcy, such as personal debt, late credit card payments, and mortgage foreclosures, are on the rise.

Question. What actions are you taking to align resources more closely with workload?

Answer.

Work Measurement Begins Summer 2007

To quantify workload changes under Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and align resources accordingly, the Judiciary will be conducting an extensive new work measurement process for the bankruptcy courts this summer. That measurement will be used to develop a new staffing formula for allocating bankruptcy resources in fiscal year 2009.

Until that time, the situation will be monitored carefully and contingency plans developed for implementation beginning in fiscal year 2008 if filings do not show a distinct upward trend by summer 2007.

Transition Planning In Progress

For each of the past five years, the bankruptcy clerks program has been downsizing to reflect its increased reliance on electronic filing as well as budget realities. In the process, the program has shed nearly 900 full-time equivalent, onboard employees, about 17 percent of the workforce.

From June through September 2007, various Judicial Conference committees will be considering proposals to continue the gradual reduction in the bankruptcy courts as warranted by filings and (pending the work measurement study) the Judiciary's best professional judgment as to workload. The process must be managed in a way so as to minimize impacts on bankruptcy court operations and staff.

Question. We recently received a draft copy of the NAPA study that was directed in the fiscal year 2006 appropriations bill.

What is the Judiciary's reaction to the findings and conclusions?

Answer. The Administrative Office has also received a draft copy of the study and is in the process of preparing agency comments. These comments will be provided to NAPA for its consideration in finalizing the report.

The Administrative Office is pleased with the report's finding that the Judiciary's budget formulation and execution activities reflect sound stewardship of federal funds and its recognition of improvements in the space area, including our relationship with GSA.

Some of the areas addressed in the report (program based budgeting and long-range planning) are issues that the Judiciary has given considerable thought to in the past and the Judiciary welcomes the opportunity to have discussions about them again, taking into account the insights presented in the NAPA report.

Question. What actions do you plan to take in the future in response to the study?

Answer. Once we receive a final report, the Judicial Conference Committees will consider the recommendations specific to their areas of jurisdiction. Depending on when the report is received, this could take place either at the summer 2007 meetings or the following winter meetings. We expect a final report in June 2007. Ultimately the Judicial Conference will determine if and how the recommendations are adopted.

Question. Please discuss your post-conviction supervision program.

How do you determine the services and support supervisees require and receive, including education, job training, and treatment?

Answer. In most cases, an offender's needs have been identified well before supervision begins, either at the pretrial or presentence stage of the Federal criminal justice system. The presentence report and the resulting sentencing document identify treatment, educational, employment, and other needs that will most likely have associated special conditions of the supervision term.

Following an offender's placement on probation or release from an institution, the probation officer works with the offender to assess the offender's risks, needs and strengths to prepare an individualized comprehensive supervision plan. Not all offenders require the same level of supervision to reach this goal. It is the officer's job to distinguish among them and to implement supervision strategies that are appropriately matched with the offender's risks, needs and strengths.

If substance abuse or mental health treatment conditions are ordered, the officer will either conduct an informed assessment or direct the person to undergo a clinical assessment performed by a professional treatment provider. If treatment is necessary, the officer refers the offender to a treatment program tailored to his needs. Treatment is part of the overall supervision objectives and strategies for the case. The officer monitors the offender's progress in treatment and collaborates with the treatment provider to further the offender's chances for success on supervision.

If the offender is unemployed, the officer determines factors contributing to the situation. Often, officers will assist offenders in finding employment or vocational training programs. Officers maintain contact with employers and educators as necessary to support the offender in meeting his supervision objectives. Many districts have implemented formal employment programs in cooperation with other agencies, such as the Department of Labor, Bureau of Prisons, local one-stop centers, state employment agencies, and local social service agencies to assist offenders in securing and maintaining meaningful employment. Many probation offices hold job fairs in their communities especially geared toward ex-offenders.

If, during the period of supervision, an officer identifies educational, vocational or treatment needs for which there is no court-ordered special condition requiring the offender participation in the program(s), the officer will petition the court to modify the release conditions accordingly. A court-ordered special condition allows the officer to leverage sanctions if the offender does not comply with the condition. In many cases, the backing of the court will induce the offender to achieve the necessary skills and/or treatment necessary to succeed on supervision and beyond. All of the above interventions, in addition to individualized professional care and concern, contribute toward the goal of increasing the likelihood of success on supervision.

Question. Do you have any data on education levels of people under supervision and do you ensure that supervisees receive a GED if needed?

Answer. If education is identified as a need for an offender who never completed high school, the officer may identify obtainment of a GED as a supervision objective. If so, the officer assists the offender in enrolling in a local educational program. The officer continually monitors the offender's progress in this type of program, as well as in many others, intended to enhance the offender's success on supervision and beyond.

The table below provides data on education levels of people under supervision. It reflects cases received for post-conviction supervision in fiscal year 2006, with education level reported.

Education Level	Number	Percent
No Education	478	1
Elementary	3,014	6
Some High School	12,726	27
GED	7,004	15
High School Diploma	10,843	23
Vocational Degree	487	1
Some College	9,471	20
College Graduate	3,183	70
Post-Graduate	775	2
Total	47,981	100

Source: National PACTS Reporting Database.

Question. The Judiciary's fiscal year 2007 financial plan and updated 2008 request both include rent reductions.

What additional actions is the Judiciary taking to reduce rent?

Answer. The Judiciary has achieved significant rent savings through its rent validation project. This initiative originated in our New York courts where staff spent months scrutinizing GSA rent bills and found rent overcharges. The cumulative effect of this discovery was savings and cost avoidance over three fiscal years totaling $30 million. The Administrative Office expanded this effort nationwide by training all circuit executive offices to research and detect errors in GSA rent billings. Although it is quite time consuming, detailed reviews of GSA rent billings are now a standard business practice throughout the courts. Through the rent validation effort we recently identified additional overcharges totaling $22.5 million in savings and cost avoidance over three years. Total savings have been $52.5 million. GSA has been very responsive to correcting billing errors that we bring to their attention. By identifying and correcting space rent overcharges we are able to re-direct these savings to other Judiciary requirements, thereby reducing our request for appropriated funds.

Question. In particular, a GAO report issued last year identified several opportunities for the Judiciary to reduce its space usage and therefore its rent costs. What has the Judiciary done in response to that report?

Answer.

GAO Recommendation #1

Work with GSA to track rent and square footage trend data on an annual basis for the following factors: (1) rent component (shell rent, operations, tenant improvements, and other costs) and security (paid to the Department of Homeland Security); (2) judicial function (district, appeals, and bankruptcy); (3) rentable square footage; and (4) geographic location (circuit and district levels). This data will allow the judiciary to create a better national understanding of the effect that local space management decisions have on rent and to identify any mistakes in GSA data.

Actions Taken By the Judiciary

The Judiciary is continuing its efforts to obtain from GSA more specific information with regard to its rent bills that will aid the judiciary in assigning costs to its various components. This effort has been quite time consuming as it requires GSA to remeasure its space and reclassify the information in GSA's database according to its type, e.g., district court courtrooms and chambers, clerk's office space, libraries, etc.

The Judiciary is also continuing its national rent validation initiative to identify mistakes in GSA data. This program has two phases that are moving forward on separate but parallel tracks. Thus far, the Judiciary has received $52.5 million in rent credits and cost avoidance for both current and prior fiscal years.

GAO Recommendation #2

Create incentives for districts/circuits to manage space more efficiently. These incentives could take several forms, such as a pilot project that charges rent to the circuits and/or districts to encourage more efficient space usage.

Actions Taken By the Judiciary

On March 14, 2006, the Judicial Conference approved, in concept, the establishment of an annual budget cap for space rental costs. The budget cap will require that local decision-makers balance competing space requests at the circuit level, so that circuit judicial councils may prioritize their space planning.

Until the implementation methodology for the rent budget cap is established (which is anticipated to be approved by the Judicial Conference in September 2007), the Judiciary has a budget check process in place that applies to any prospectus or non-prospectus space request that has the potential to affect rent. Every such project must be approved by the Judicial Conference of the United States before it can proceed.

GAO Recommendation #3

Revise the Design Guide to: (1) establish criteria for the number of appeals courtrooms and chambers; (2) establish criteria for space allocated for senior district judges; and (3) make additional improvements to space allocation standards related to technological advancements (e.g., libraries, court reporter spaces, staff efficiency due to technology) and decrease requirements where appropriate.

Actions Taken By the Judiciary

Over the last two years, the Judicial Conference of the United States approved multiple reductions to the space standards set forth in the U.S. Courts Design Guide that have reduced staff office sizes and chambers space for senior, district, appellate, bankruptcy and magistrate judges. In addition, the Committee on Space and Facilities plans to consider the criteria for the number of appeals courtrooms. Finally, the Judicial Conference approved technical amendments including reductions in atrium, lighting, and HVAC systems that will result in cost savings.

As to the impact of electronic filing on court space, the judiciary has reduced Design Guide requirements for some of the clerk's office space, including intake areas and records storage, due to the impact of the electronic case filing/case management system and has reduced the library space by 13 percent due to reductions in lawbook collections.

SUBCOMMITTEE RECESS

Senator DURBIN. I thank you for your attendance today. And the subcommittee hearing is recessed.

[Whereupon, at 4:15 p.m., Wednesday, March 21, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

WEDNESDAY, MARCH 28, 2007

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3:58 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin and Allard.

DEPARTMENT OF THE TREASURY

OFFICE OF THE SECRETARY

STATEMENT OF HON. HENRY M. PAULSON, JR., SECRETARY

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. This meeting of the Senate Appropriations Subcommittee on Financial Services and General Government will come to order.

We continue our budget hearings today with the Department of the Treasury. We welcome Secretary Henry Paulson to the hearing, along with his associates and my colleagues, who will be joining me, I'm sure, after the rollcall vote. I apologize for the delay in beginning, but we scheduled rollcalls and it changed our timing.

This is a budget hearing for the Treasury Department. We'll defer most of the questions pertaining to the Internal Revenue Service (IRS) until April 18, when Commissioner Everson will appear. The IRS represents 90 percent of the Treasury budget, in terms of actual dollars; the remaining 10 percent contains some very critical activities and programs, which we'll talk about today.

I was pleased, during consideration of the recent continuing resolution, we were able to provide some additional funds for the Department. We do have a budget request for next fiscal year from the Treasury, of about $12.140 billion, an increase of $514 million, or 4.4 percent. Excluding the IRS, the request for the remainder of the Department is $1.45 billion, a net increase of $16 million over the last fiscal year, or 1.5 percent. This appears, at first glance, to be a very tight budget for the Treasury Department.

I have a number of areas of concern, which I will save for the question period. It is now my pleasure to welcome the Secretary to the hearing.

Mr. Secretary, the floor is yours.

STATEMENT OF HENRY M. PAULSON, JR.

Secretary PAULSON. Mr. Chairman, thank you very much.

I've submitted a longer statement for the record. I had a shorter statement that I was going to read, and I just think, in the interest of brevity, what I'll do is, I'll just read two paragraphs of the shorter statement and submit that for the record also, because, as you know, and as you've said, Treasury has a broad and important role in maintaining the economic and national security of this Nation and ensuring the effective operation of the Government, and I'm continually impressed with the caliber of professionalism of Treasury's employees, particularly the career staff, who carry out this work every day.

Now, we have established four priorities in this budget for next year: maintaining the growth and competitiveness of the U.S. economy for the benefit of all our workers and families; investing in tax enforcement and taxpayer services, because it is important that individuals and business pay what they owe; promoting strong economic ties and balanced trade relationships with foreign nations, including China; and continuing our important contribution to the war on terror by choking off terrorist financing and other illicit activities.

PREPARED STATEMENT

Senator DURBIN. Without objection, your entire statement will be made part of the record.

Secretary PAULSON. Good.

[The statement follows:]

PREPARED STATEMENT OF HENRY M. PAULSON, JR.

Chairman Durbin, Senator Brownback, and members of the subcommittee. Thank you for the opportunity to appear before you today to discuss the President's Fiscal Year 2008 Budget for the Department of the Treasury.

I am pleased to be here today to provide an overview of the President's Budget for Treasury in fiscal year 2008. The President's Fiscal Year 2008 Budget reflects the Department's budget priorities and dedication to promoting economic growth and opportunity, strengthening national security, and exercising fiscal discipline.

The $12.1 billion request focuses resources on key programs necessary to promote economic growth, fund the activities of the Federal Government and effectively fight the war on terror. The request is $523 million above the amount provided by the fiscal year 2007 funding level, a 4.5 percent increase. By collecting the revenue due to the Federal Government and working to reduce illicit threats to the financial system, the Department of the Treasury contributes to the financial integrity of the United States.

Treasury has a primary role as steward of the U.S. economic and financial systems, including the role of the United States as an influential participant in the international economy. Treasury promotes financial and economic growth at home and abroad. Treasury also performs a critical and far-reaching role in national security. The Department battles national security threats by coordinating financial intelligence, targeting and imposing sanctions on supporters of terrorism, narcotics traffickers, and proliferators of weapons of mass destruction, improving the safeguards of our financial systems, and promoting international relationships to combat the financial underpinnings of terrorist and other criminal networks.

Managing these complex tasks requires expanded capabilities. Fully funding the President's Fiscal Year 2008 Budget request will allow the Treasury Department to continue and improve its ability to study, recommend, and support initiatives that strengthen the U.S. economy, create more jobs for Americans, and enhance citizens' economic security. The Department will actively work to protect the security of pen-

sions, reform Social Security, and improve the Federal income tax system by providing timely, usable, and comprehensive analyses that advance the policy process.

PROMOTING ECONOMIC GROWTH, SECURITY AND OPPORTUNITY

The Treasury Department works diligently to fulfill its role as the administration's chief economic advisor. We strive to provide the President with the best information available on a broad range of domestic and international economic issues. Treasury's Offices of International Affairs, Tax Policy, Economic Policy, and Domestic Finance support this role through the provision of technical analysis, economic forecasting, and policy guidance on issues ranging from federal financing to responding to international financial crises. The Treasury Department supports policies that stimulate U.S. economic growth, strengthen and modernize entitlement programs, and minimize regulatory burdens while ensuring the safety and soundness of financial institutions.

The fiscal year 2008 budget request funds Treasury's efforts to promote domestic and international economic growth through financial diplomacy. Treasury stimulates economic growth and job creation by working to open trade and investment, encouraging growth in developing countries, and promoting responsible policies regarding international debt, finance, and economics. Treasury supports trade liberalization and budget discipline through its role in negotiating and implementing international agreements pertaining to export subsidies. These agreements open markets, level the playing field for U.S. exporters, and provide effective subsidy reductions that save the U.S. taxpayer millions of dollars annually. Since 1991, cumulative budget savings from these arrangements are estimated at over $10 billion. The growth of these activities makes it necessary to enhance policy coordination and resources through the addition of regional experts. Treasury's fiscal year 2008 budget request provides additional staff to support key policy dialogues around the globe. These experts will enhance policy coordination on international matters and will support key policy dialogues with priority countries like China.

Treasury also remains committed to protecting the homeland from international investments that may threaten our national security. The Committee on Foreign Investment in the United States (CFIUS) is an interagency group responsible for investigating the national security implications of the merger or acquisition of U.S. companies by foreign persons. One of my key responsibilities as Secretary is to chair this committee, and to make sure that the interagency CFIUS process performs as efficiently as possible. As foreign investment in the United States has increased, so has the number of cases reviewed by CFIUS. As a result, the fiscal year 2008 budget request provides additional resources to support Treasury's investigations of foreign investments.

The President's fiscal year 2008 request for Treasury also includes $28.6 million for the Community Development Financial Institutions (CDFI) fund. CDFI fund's mission is to expand the capacity of financial institutions to provide credit, capital, and financial services to underserved populations and communities in the United States. In order to ensure that the CDFI program continues to operate in the most efficient and effective manner, Treasury is proposing to phase out the CDFI Bank Enterprise Awards (BEA) program in 2008. There is no evidence that the BEA program improves economic development, and we believe that the program's goals are better served through other CDFI fund activities.

STRENGTHENING NATIONAL SECURITY

The sponsorship of terrorism and potential acquisition of weapons of mass destruction (WMD) by rogue regimes and non-state entities represent grave threats to U.S. national security and the security of all free and open societies. Terrorists, WMD proliferators and other non-state threats require support networks through which money and material flow. The Treasury Department draws on financial and other all-source intelligence, and also works to utilize its unique regulatory and law enforcement authorities, to combat national security threats and safeguard the financial system.

The Department's Office of Terrorism and Financial Intelligence (TFI) provides financial intelligence analysis, develops and implements systems to combat money laundering and terrorist financing, administers the Bank Secrecy Act, and administers and enforces the U.S. Government's economic sanctions programs.

Treasury exercises a full range of intelligence, regulatory, policy, and enforcement tools in tracking and disrupting terrorists' support networks, proliferators of weapons of mass destruction, rogue regimes, and international narco-traffickers, both as a vital source of intelligence and as a means of degrading their ability to function. Treasury's actions include:

—Freezing the assets of terrorists, proliferators, drug kingpins, and other criminals and shutting down the channels through which they raise and move money;
—cutting off corrupt foreign jurisdictions and financial institutions from the U.S. financial system;
—developing and enforcing regulations to reduce terrorist financing and money laundering;
—tracing and repatriating assets looted by corrupt foreign officials; and
—promoting a meaningful exchange of information with the private financial sector to help detect and address threats to the financial system.

The fiscal year 2008 President's Budget will enable Treasury to enhance these capabilities. Treasury requests funding for investments to further the Department's national security mission in three critical areas. First, this budget, if enacted, will enable Treasury to expand its capacity to identify potential national security threats and to enforce U.S. policies to counter those threats. Next, Treasury will enhance the information technology and physical infrastructure of TFI and its component bureaus and offices to improve data security, access, and quality. Finally, the budget would provide funds to help integrate TFI's Office of Intelligence Analysis into the broader intelligence community.

Specifically, this request includes an additional $5.3 million to respond to emerging national security threats, provide strategic policy coordination in regions key to the fight against terrorist financing, and to enhance implementation of sanctions against state sponsors of terrorism and WMD proliferation. The request also includes $8.1 million for infrastructure and information technology projects to enhance data access, security, and quality, including construction of a Sensitive, Compartmented Information Facility (SCIF), stabilization and maintenance of the Treasury Foreign Intelligence Network, and the Critical Infrastructure Protection program. Finally, $1 million is requested for initiatives to further Treasury's integration into the broader intelligence community.

The Financial Crimes Enforcement Network (FinCEN) is responsible for administering the Bank Secrecy Act (BSA). The fiscal year 2008 budget request provides funding to strengthen recovery capability for mission-critical information technology systems and emergency operation capabilities; and improve information technology planning and oversight.

MANAGING U.S. GOVERNMENT FINANCES

The Treasury Department manages the Nation's finances by collecting money due the United States, making its payments, managing its borrowing, investing when appropriate, and performing central accounting functions. Key priorities in managing the government's finances include maximizing voluntary compliance with tax laws and regulations, continually improving financial management processes, and financing the government at the lowest possible cost over time. The fiscal year 2008 budget request provides the funding necessary to properly administer these functions.

Collecting Taxes

Collecting taxes in a fair and consistent manner is a core mission of the Treasury Department. Treasury's priorities in tax administration are enforcing the Nation's tax laws fairly and efficiently while balancing taxpayer service and education to promote voluntary compliance and reduce taxpayer burden. In an effort to maximize tax compliance, the fiscal year 2008 budget includes $11.1 billion for the IRS, which is an increase of $498 million above the amount provided in the fiscal year 2007 funding levels.

The fiscal year 2008 budget request provides funding to enhance coverage of high-risk compliance areas, as well as to address the tax gap, which represents the annual difference between taxes owed and taxes collected, including a multi-year research effort that will provide continuous feedback on noncompliance. Enforcement will focus on critical reporting, filing, and payment compliance programs, and highlight abusive tax avoidance transactions and high income individual examinations involving pass-through entities (e.g., partnerships and trusts). The IRS will also continue to reengineer its examination and collection procedures to reduce audit time, increase yield, and expand coverage. As in fiscal year 2006 and fiscal year 2007, the administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment.

The IRS will continue efforts to improve services offered to taxpayers, primarily focusing on those outside of traditional telephone access. For example, the fiscal year 2008 request provides funding to expand the Volunteer Income Tax Assistance program. The IRS will also implement the Taxpayer Assistance Blueprint, a 5 year

strategic plan to deliver taxpayer service; a collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate.

Finally, the fiscal year 2008 request will allow the IRS to make critical IT infrastructure upgrades. IRS will continue to invest in technology, process improvements, and training to achieve consistent quality service with reduced costs. The budget also includes funding for the IRS's Business Systems Modernization program, which is designed to provide IRS employees the tools they need to continue to administer and improve both service and enforcement programs.

The President's budget also includes a number of legislative proposals intended to improve tax compliance with minimum taxpayer burden. Once implemented, it is estimated that proposals will generate $29 billion over 10 years. These proposals are presented in detail in the fiscal year 2008 Department of the Treasury Blue Book. The legislative proposals fall into four categories: expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties.

Treasury's Alcohol and Tobacco Tax and Trade Bureau also collects excise taxes on alcohol, tobacco, firearms, and ammunition. In fiscal year 2006, the bureau collected $14.8 billion in excise taxes, interest, and other revenues on these products and also regulates the manufacture of alcohol and tobacco products.

Ensuring Efficient Fiscal Service Operations

The fiscal year 2008 budget request provides the funds necessary for Treasury to meet its responsibilities as the Federal Government's financial manager.

Treasury's management of the Federal Government's finances includes making payments, collecting revenue, preparing public financial statements and collecting delinquent debt owed to the Federal Government through the Financial Management Service (FMS). Treasury oversees a daily cash flow in excess of $58 billion and disburses 85 percent of all federal payments. The Department is working to improve its payments and collections processes by moving toward an all-electronic Treasury. In fiscal year 2006, Treasury issued 742 million electronic payments including income tax refunds, Social Security benefits, and veterans' benefits. Treasury is also encouraging Social Security and Supplemental Security Income recipients to switch to Direct Deposit through the Go Direct campaign. Direct deposit represents a cost savings to the Federal Government, and consequently to the American taxpayer, of 80 cents per transaction compared to a check payment.

Treasury's Bureau of the Public Debt manages all of the public debt, which includes marketable securities, savings bonds, and other instruments held by State and local governments, federal agencies, foreign governments, corporations, and individuals. To improve debt management and offer better customer service, Treasury offers TreasuryDirect, an electronic, web-based system that electronically issues securities to retail customers and enables investors to manage their accounts on-line.

The budget also includes three legislative proposals for FMS that are estimated to save the Federal Government over $3 billion over 10 years. These proposals will allow the government to trace and recover federal payments sent electronically to the wrong account, eliminate the 10-year limitation on the collection of delinquent non-tax federal debts, and remove the disincentive for the IRS to refer tax debts to FMS for collection.

STRENGTHENING FINANCIAL INSTITUTIONS

One of the principal objectives of the Treasury Department is to enable commerce. The Department is responsible for the safety and soundness of national banks and federally-chartered savings associations. The Treasury Department also produces the coins and currency needed for commerce, and guards against counterfeiting and other misuse of our money. While the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the U.S. Mint (Mint), and the Bureau of Engraving and Printing (BEP) are funded through direct annual appropriations, their contribution to Treasury's mission cannot be understated.

Treasury, through OCC and OTS, maintains the integrity of the financial system of the United States by chartering, regulating, and supervising national banks and savings associations. In fiscal year 2006, OCC and OTS oversaw financial assets held by these financial institutions totaling $8.1 trillion.

The Mint and BEP are responsible for producing the Nation's coins and currency, respectively. In fiscal year 2006, the Mint and BEP produced 16.2 billion coins and 8.2 billion paper currency notes, respectively. The Mint issued five new quarters for the 50 State Quarters program and BEP introduced the new $10 currency note into circulation. Also, despite significant increases in the price of metals, the Mint was able to return $750 million to the Treasury General Fund in fiscal year 2006.

Managing Treasury Effectively

Treasury is committed to using the resources provided by taxpayers in the most efficient manner possible. The Department will drive improved results through decision-making that considers performance and cost. The Treasury Department strives to serve its stakeholders in the most effective way while working to leverage resources across the Department and across government.

Funding requested in Treasury's departmental offices and Department-wide Systems and Capital Investments Program (DSCIP) is sought for building a strong information technology infrastructure, ensuring that Treasury remains a world-class organization that meets the President's standard of a citizen-centered, results-oriented government.

The DSCIP account funds technology investments to modernize business processes throughout Treasury, helping the Department improve efficiency. In fiscal year 2008, Treasury requests $18.71 million for ongoing modernization and critical information technology infrastructure projects, and for investment in other new technologies that will improve efficiency and service to the American people. The budget request includes:

—$6 million to begin work on a Treasury-wide Enterprise Content Management System. The initial system will meet the business requirements of the Office of Foreign Assets Control and the Financial Crimes Enforcement Network;

—$2 million for the continued stabilization of the Treasury Secure Data Network; and

—$4 million to improve Treasury's FISMA performance, strengthen the Department's overall security posture, leveraging the President's management agenda, including the E–Government initiatives, across the Department.

This budget request also includes funding for the Office of the Inspector General and the Treasury Inspector General for Tax Administration. These offices play important oversight roles in the overall management of the Department and the fair administration of the Nation's tax laws.

CONCLUSION

Mr. Chairman, thank you again for the opportunity to come here today to discuss with you and the committee the President's Fiscal Year 2008 Budget request for Treasury. I look forward to working with you and the members of the committee in ensuring that Treasury maximizes its resources and funding so that the American people can be assured that their tax dollars are being used in the most effective way possible. I would be more than happy to answer any questions.

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS PROGRAM

Senator DURBIN. Let me zero in on a few issues that I think I'd like to raise.

The first relates to the community development financial institutions (CDFI). Since its inception, CDFI has sought to increase the availability of credit, investment capital, and financial services to relatively poor urban and rural communities. The fund pursues these objectives by augmenting the private resources for investment in economic development, housing, banking services. It works with two sets of partners in boosting such investment: private financial institutions, certified by the CDFI as community development financial institutions, and private equity groups.

Now, the administration's budget request includes a request for $28.5 million for this CDFI fund. This is an improvement over last year's budget request, but it is a reduction of nearly 50 percent from the fiscal year 2007 amount of $54.5 million. And $12.2 million of your fiscal 2008 request consists of administrative costs which are necessary, but really don't provide the capital that we're talking about for these institutions.

I'd like to ask you—and I'm going to give you just an illustration of why I think this needs to be discussed. According to the Treasury's own calculations, every dollar the Federal Government invests in the CDFI funds leads to another $27 in non-Federal fund

investment. So, meeting the CDFI community request of $100 million, instead of the Treasury Department request of $28.5 million, would cost the Government only an additional $71.5 million, but would provide needy communities over $1.9 billion. That's based on the Treasury's calculations.

Based on the data provided by the Opportunity Finance Network, which advocates on behalf of CDFIs, and on calculations made by my staff, here's the difference that $1.9 billion into inner-cities, rural communities, and Native American reservations would mean: 28,000 jobs, 6,000 new businesses, 64,000 extra housing units, and 1,000 new or improved community facility projects. Isn't that worth $71 million?

Secretary PAULSON. Mr. Chairman, first of all, thanks for your question. Second, this is a good program, so we're not debating this. As you've pointed out, we increased our request this year, and did it meaningfully, although below the funded level. It's something I've looked at carefully, myself. We'd be happy to work with you on this. We have a few differences, maybe, on which parts are the most valuable parts of the program. And so, we can talk about that. But I agree with your basic assertion that this is a good program.

Senator DURBIN. I'm going to get into this a little more with you directly in conversation——

Secretary PAULSON. Sure.

Senator DURBIN [continuing]. To talk about this, because I think I've made a point for the record, and you've——

Secretary PAULSON. We would like——

Senator DURBIN [continuing]. Left an opening for further discussion.

Secretary PAULSON. And we'll work with you—we've got someone new that's running this. I'd be happy to send her up to work with——

Senator DURBIN. Good.

Secretary PAULSON [continuing]. Your staff, and would be happy to get involved, myself.

INFORMATION TECHNOLOGY MANAGEMENT

Senator DURBIN. Thank you.

The inspector general, in his October 16, 2006, memorandum to you concerning management and performance challenges facing the Department, indicated that the Department has difficulties in managing large acquisitions of mission-critical systems and other capital investments. What changes have you made to improve your performance in managing the Department's information technology (IT) projects? Why will this year be better?

Secretary PAULSON. Well, let me say, the report happens to be right, that there are problems, and there have been problems. And it's not easy to correct them all at once. I would say part of them relate to having the right people in the right jobs. We're looking for a new Assistant Secretary of Management, and I think we're close to announcing something there. We're also looking for a new CIO for the Department. And getting those people in place, when we find them, will be important. But it also takes, I think, an integrated approach to this. Bureau heads and key managers have to

also buy into this and recognize that managing the IT programs has got to be part of their day-to-day business. It takes training, and we've instituted a number of things in the training area. So, I would say I've been here 8 months; before I came, I had Senator Bond take me aside and tell me there were problems. And he was right.

Senator DURBIN. Since you've been here 8 months, and you come from some of the highest levels of the private sector, it—I don't have that same life experience that you've had. I continue to be puzzled, in Federal agency after Federal agency, why they have such a difficult time with information technology. Does the private sector go through the same pain?

Secretary PAULSON. Well, I would say this. In the private sector, I don't believe I knew a CEO that said, "I'm really happy with my IT. I know that I'm spending all the money properly, that we're getting and doing everything we should, that it's working as well as it should." And I know, in the company I came from, we felt a big part of it. The IT professionals, the CIOs, were important, but every manager had to take responsibility for it, and it couldn't be something separate, it had to be part of their business. I know it is difficult in the private sector when you can offer a lot of money. I know people work for a lot of things, and one of the things I've learned since coming here is how hard people work, how Treasury's got great people and great career people, and the people that are filling in, in these jobs right now, are doing a good job. But it is not easy to find people who are really qualified. And then, the change of culture to make it work isn't easy. But I think the Government overall has problems, and to the best of my judgment, maybe Treasury has a few more problems than some other areas, but I haven't been in some of the other areas. But we're on top of them, and we're doing everything we can. And I think we're making some progress.

BANK SECRECY ACT DIRECT

Senator DURBIN. Let me move to another issue. In June 2004, Treasury established the Bank Secrecy Act (BSA) Direct Retrieval and Sharing Program. This program was designed to make it easier for law enforcement to access and analyze BSA data and to improve our overall data management.

Secretary PAULSON. Right.

Senator DURBIN. On July 13, 2006, the Financial Crimes Enforcement Network (FinCEN) halted the program due to problems with its main contractor. Robert Werner, then director of the program, testified, in September, that the Financial Crimes Enforcement Network is initiating a replanning effort, in his words, for the retrieval and sharing component of the Bank Secrecy Act Direct. Where does this stand, at this point? Tell me about your efforts to improve the sharing of BSA data between Treasury and law enforcement.

Secretary PAULSON. Well, I think we're making progress. But, again, this is in some ways, the same answer to the question that I gave that—in other words, our IT and technology programs throughout Treasury had issues and weren't up to snuff. We've got this up and going. I think we're making progress, in terms of shar-

ing information. I think it's working pretty well. But I'm not going to tell you that we didn't have systems problems.

Senator DURBIN. This predates your arrival.

Secretary PAULSON. Right.

Senator DURBIN. This has been an ongoing issue for 4 years. And we have tried to, with Director Mueller, at the Federal Bureau of Investigation (FBI), and so many other agencies, Homeland Security. I really, kind of, focused on a theme, because I couldn't execute it with any personal knowledge, but the theme was to upgrade information technology and the opportunities for sharing information when it came to security and law enforcement. And what you've just said—I'm not surprised, but it's the same thing that's been said before. And I hope that your expertise in the private sector will help break through some of these problems.

Secretary PAULSON. We're making progress. I would say this. I gave you the negative. The positive is, if I've been surprised on anything on the upside, it's been the quality of the professionals—career professionals who we have at Treasury that are doing this job. And the work that gets done is first-class work, even when we don't have the best systems. And we're approaching this, and we're determined to make some progress here.

TREASURY FOREIGN INTELLIGENCE NETWORK

Senator DURBIN. I believe you've identified the Treasury Foreign Intelligence Network as your top IT development priority. What's the current status of that system?

Secretary PAULSON. I think we're back on track. It's operating. Again, with any of these systems, I'm not going to tell you, with 100 percent certainty, until we get our new Assistant Secretary of Management, and our new CIO in place, but we've done a bit more work——

Senator DURBIN. What is the timetable for filling those spots?

Secretary PAULSON. Soon. I think we're weeks away, knock on wood, from being able to get an Assistant Secretary of Management in place, and I think it may take a little bit longer on the CIO.

TERRORIST FINANCING

Senator DURBIN. One of your critical responsibilities relates to terrorism and financing of terrorism, in the Office of Terrorism and Financial Intelligence (TFI). They seek to integrate the operations and resources of the Office of Terrorist Financing and Financial Crime, the Office of Foreign Assets Control, the Financial Crimes Enforcement Network, and others. Two basic responsibilities of TFI, gather and evaluate financial intelligence, and, two, enforce various financial laws and regulations relative to that intelligence. What do you see as some of the major challenges facing the Office of Terrorism and Financial Intelligence?

Secretary PAULSON. First of all, this is a very important area, and we've got first-class people. Part of what we ask for in our budget is money to build the new SCIF, and to hire and train additional people, because we've got first-rate individuals that work very hard, so that is obviously part of it. The team, I believe, works quite well with others in the intelligence community and, in a number of programs, we play a support role, working with col-

leagues at State or elsewhere. I think the teamwork is good there. But this area, like anything else, comes down to having the right people in the right jobs, and asking—are they trained well? And are they thinking creatively? And are they working as part of a team? You're talking about an area that I think is as well managed as any area at Treasury, with first-rate professionals.

Senator DURBIN. Mr. Secretary—before I turn it over to my colleague Senator Allard—there's an article in yesterday's Washington Post; it spoke of private business, such as rental and mortgage companies, car dealers, checking the names of customers against a list of suspected terrorists and drug traffickers, made publicly available by the Treasury Department, sometimes denying services to ordinary people whose names are similar to those on the list. The Office of Foreign Asset Control (OFAC) list of specially designated nationals has long been used by banks and other financial institutions to block financial transactions of drug dealers and other criminals, but an Executive order issued by President Bush after the September 11 tragedy has expanded the list and its consequences in unforeseen ways. Businesses have used it to screen applicants for home and car loans, apartments, and even exercise equipment, according to interviews in a report by the Lawyers Committee for Civil Rights of the San Francisco Bay area. To what extent is this list put out by the Office of Foreign Asset Control creating problems for average consumers in this country?

Secretary PAULSON. That's a very good question, and it's something we've talked about and had a number of meetings about. Clearly, these activities that we have to disrupt terrorist financing, to deal with weapons proliferation, and to deal with other illicit activities, are very important. So, we're very careful, in terms of when we publish the list, to get the name right and to have the birth date. And then, what you're dealing with is this. These sanctions need to be public, and so you'll have a number of credit bureaus which will take a look at the list and then, if there's a name that's similar or if the name may be the same, but doesn't have the same birthday or whatever, they'll put a flag by it. And then, in some instances, you'll find examples of businesses or others that just don't want to be bothered, or for whatever reason, aren't as careful as they should be in denying credit.

Senator DURBIN. Well, it seems like that would create a pretty serious hardship on some people—innocent people.

Secretary PAULSON. It does, and it's something we're concerned about. Now, what we do is, we've got a hotline that is open 24 hours a day. There are many, many, many calls. And Treasury is very quick about this. There are people that call because the name is similar, but not exact, or the name is the same but there's a different birth date. And these things get answered and get cleared up very quickly. So, how do we do this, and have you got any ideas? We ask ourselves, what can we do? We've got people manning these hotlines. There are literally thousands and thousands. The number that sticks in my mind is 90,000 calls over the last year, which received very quick answers. Whenever you have any list with sanctions, there's room for confusion if people don't use it properly. And Treasury's doing everything they can to make sure it is used properly.

Senator DURBIN. Let me recognize the Senator from Colorado.

Senator ALLARD. Well, thank you, Mr. Chairman, for holding this hearing.

I understand, in your opening remarks, you said you're going to have a separate hearing on the Internal Revenue Service. And I'm going to have some questions then, but I do have an opening statement I'd like to have made a part of the record, if we might.

Senator DURBIN. Without objection. We will also insert the statement from Senator Brownback.

[The statements follow:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Durbin for holding today's hearing.

The Treasury Department encompasses a number of important responsibilities, ranging from managing the government's accounts and the public debt; creating coins, currency, and stamps; supervising banks and thrifts; managing and promoting the domestic economy; promoting international trade and finance; detecting and preventing terror finance, money laundering, and other financial crimes; to administration of the tax code and collection of taxes owed. The breadth of these responsibilities perhaps belies the size of the $12.1 billion budget request.

While there are a number of areas of interest within the Treasury Department, I have the opportunity to delve into many of them on the Banking Committee; therefore, I intend to use my time today to examine some current practices of the Internal Revenue Service.

For some time now I have been concerned by increasingly hostile IRS actions towards conservation easements. Colorado has been a national leader in this area, so it is particularly worrisome to my constituents that the IRS is targeting legitimate easements for audits. It would appear that the IRS is attempting to dramatically narrow the number of legitimate conservation easements by applying a standard that has been struck down by federal courts two different times.

While I support investigation and enforcement of legitimate fraud, we must not target honest taxpayers, and Colorado's reputation should not be tarnished. There is a significant need for conservation easements in Colorado, and a few abuses should not end the charitable tax credit for everyone.

I have been in communication with the IRS over this matter for some months, however, I have been very frustrated that I am unable to get answers to my questions on this matter. Therefore, I will follow up with the Secretary in more detail during the question and answer period.

I would like to thank Secretary Paulson for appearing before the subcommittee. I recognize that he has a very busy schedule, so I appreciate his presence and look forward to his testimony.

PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Good afternoon. I want to thank you, Chairman Durbin, for your leadership of this new subcommittee. I look forward to working together with you during this coming year as we make funding decisions and provide oversight to the various agencies within this subcommittee's jurisdiction.

Secretary Paulson, thank you for appearing before our subcommittee today. I look forward to hearing the details of your fiscal year 2008 budget request and the key efforts that your Department will be undertaking this year.

Looking at the President's budget, I am pleased that it assumes the continuation of the President's tax cuts, which have helped our economy rebound from recession to its current robust health. I am also pleased that the economy is continuing to grow steadily and am encouraged that the President's budget projects a balanced budget in 2012.

Mr. Secretary, the lion's share of your budget—approximately 90 percent—is for the Internal Revenue Service. I understand that you are seeking additional resources to close the so-called "tax gap." Certainly, we must ensure that taxes which are owed are collected. However, I remain concerned that our tax system is overly complex, complicated, and burdensome. Americans spend roughly $157 billion each year in tax preparation to ensure they do not run afoul of the IRS. The system is desperately in need of reform. I support a flat tax concept that simplifies tax preparation, applies a low tax rate to all Americans, and respects the special financial

burden carried by American families raising children. One reason we have a "tax gap" may be that our tax system is so complex that taxpayers cannot figure out what they owe.

Mr. Secretary, I want to commend your Department for its efforts to combat terrorism. Your "Office of Terrorism and Financial Intelligence" is working hard to safeguard the financial system against illicit use and combating rogue nations, terrorist facilitators, money launderers, drug kingpins, and other national security threats. This is important work and I am supportive of your efforts in this area.

I understand that the President has asked the Treasury Department to aggressively block U.S. commercial bank transactions connected to the government of Sudan, including those involving oil revenues, if Khartoum continues to balk at efforts to bring peace to Sudan's Darfur region.

We know that Sudan's economy is largely dollar-based, meaning many commercial transactions flow through the United States. This fact makes Sudan vulnerable to your Department's actions. Anticipating Treasury's actions, there have been reports that Khartoum is exploring ways of obtaining oil revenues that do not involve dollars, such as barter deals. Clearly, we have an opportunity here to put greater pressure on Khartoum to enter into peace negotiations. Mr. Secretary, I am wholeheartedly supportive of these efforts and I would like to hear what actions you plan to take in the coming weeks and months.

Mr. Secretary, I look forward to hearing your testimony this afternoon. Your Department has an important role as the steward of our financial systems and in promoting our participation in the international economy.

Thank you for your leadership, Mr. Chairman. I look forward to working with you this year.

TAX ENFORCEMENT

Senator ALLARD. And I do want to ask a few questions related to the Internal Revenue Service, because it's an evolving issue in Colorado, and very important, and that has to do with conservation easements. The Congress passed some specific legislation providing for conservation easements, which is an incentive to have open space, you know, in your State. And what is happening in the State of Colorado is that the commissioners there, or the enforcers there, have—seem to be taking enforcement action that's over and beyond what's provided for in the legislation. They're being—they're interpreting it in a more strict way. It's, twice, gone to the courts, have been on—and the Internal Revenue has been overruled in the courts on two cases. And so, my question is, is why—after they've been overruled twice in the courts, why they're continuing to push this. I hope that you're aware of this. If you're not—and, if you are, somewhat, I'd like to get a response; if not, we can follow up with this when we're having the hearing on the Internal Revenue Service.

Mr. Secretary, do you have a response to that?

Secretary PAULSON. I'm not familiar with the issue, but I think you're right to follow up with Commissioner Everson. I think he would be the appropriate person to talk with about that.

Senator ALLARD. Well, I hope you have him adequately briefed, and tell him that I'm going to be waiting for him. And—hope I don't have—I hope I can be here, but I'm going to make every effort to be here, because I think this is really important.

Secretary PAULSON. Good.

Senator ALLARD. And then, also—and it's not that I don't think we ought—shouldn't be doing more to enforce our tax laws; I think we ought to be doing more. And I—you know, we're—there's actual—in the budget, more money, with the idea there's going to be more strict enforcement on collecting from those who are not paying their taxes.

PART PROGRAM

Now, in regard to that, you're familiar with the PART Program? This is the President's program, where he asked the agencies to set up goals and objectives; and then, if you don't meet those goals and objectives, or if you don't even bother to set those up, then there's a rating system that goes into that. And that is—you can find that PART Program rating on the Internet, by the way; you go to—the ExpectMore.gov—and if you go there, you'll find that there's one of your agencies that is rated as ineffective. If you were—if it was a classroom, that would be an "F." And it's the Internal Revenue Service earned income tax credit compliance (EITC). Have you looked at that particular program? Why is it ineffective?

Secretary PAULSON. Well, I would, respectfully, disagree, because this is something that I have looked at and spent some time with. I have actually spent some time with a number of people in the House and in the Senate, have gone out to a center, with John Lewis and Charlie Rangel, and here's the issue with the EITC.

Senator ALLARD. Now, this is the compliance aspect of EITC.

Secretary PAULSON. I understand that.

Senator ALLARD. Yes.

Secretary PAULSON. I'm going to get to that. And I'm going to say you should take a look sometime at the form and 53 pages of instructions. This is an area where it's easy to make mistakes. I sometimes get questions from the other side, which say, "Tell us why Everson and the IRS have so many people auditing this area, as opposed to the high net worth." And, I explain it's a totally different function. The audit is done from remote locations, and it is just looking at the forms, and checking for mistakes and errors and inconsistencies, which is a very different type of function. And it's not possible to transfer those people to do other things. So, we're doing our best. And we have quite an outreach program this year to help with the education, and we will, hopefully, as we move into the next tax season, find ways to simplify the form and make it easier. But, again——

Senator ALLARD. Well, I think that's key. And that was going to be my next question. You know, we need to—it seems to me like that needs to be simplified, and, hopefully, that that's within your purview to do that, and more clearly define goals and objectives so people understand where they're going to be, and put it in terms in which they can be measured.

Secretary PAULSON. Right. And you should ask, when he's here, because, he's spent a lot of time on this, himself—Commissioner Everson.

Senator ALLARD. Now, there are some programs under your purview that show "results not demonstrated." And the way those are explained to me is, those agencies have done nothing, or very little, to try and set up any measurable goals and objectives. And, in the Treasury, we have global environment facility of the Internal Revenue Service, healthcare, tax credit administration, Internal Revenue Service tax collection, Tropical Forest Conservation Act—are just a few that is named—are listed on here. Why aren't those agencies—why haven't they done anything at all to try and comply with PART? Why is their rating "results not demonstrated?"—and

that's what that means, that they haven't been able to put together a management objectives program.

Secretary PAULSON. Well, I can't, again, accept the assertion that, with these programs or these areas, we don't have people that are working to achieve objectives. And if you would like to pick any of those programs that are of particular interest to you, I'd be happy to discuss it further and have the people involved come up and spend some—

Senator ALLARD. Well, they're of interest to me, because I'm on the Budget Committee and I'm on the Appropriations Committee.

Secretary PAULSON. Right.

Senator ALLARD. And I want to—I want to see taxpayer dollars spent on programs where we get results that has more——

Secretary PAULSON. Right.

Senator ALLARD [continuing]. We don't want programs out there running that have empty promises.

Secretary PAULSON. Well, I——

Senator ALLARD. And so, the reason for this whole program is that we have—the taxpayer dollars are going to programs that create measurable results, so that, as policymakers, we—and, as you know, this is—this evaluation is done by the Office of Management and Budget (OMB). And I suggest that maybe you sit down with them, see what you need to be doing, and—I'm just—what I'm trying to do, on this hearing, is to highlight it for you——

Secretary PAULSON. Right.

Senator ALLARD [continuing]. So that next year when you come in, you won't be—you'll know that we'll be looking at these—that this makes a difference in our thinking.

Secretary PAULSON. Well, let me give you an example, just on one of the programs, which is the global environmental fund. This is a multilateral fund that deals with environmental issues. And, in that case, we, the U.S. Government, have underfunded our request and our obligation, globally. And so, this is one where I know we had held back, because we had felt that certain objectives weren't being met. This year, we decided to fund it more fully, because we felt it was appropriate. And so, that's one. In terms of how someone in PART did the analysis, I can't comment on it.

Senator ALLARD. Well——

Secretary PAULSON. I can just tell you that we looked very carefully at everything we put in the budget.

Senator ALLARD. Well, we get down to the——

Secretary PAULSON. Right.

Senator ALLARD. I mean, I commend you for looking at that and evaluating it, and maybe it does need more money.

Secretary PAULSON. Right.

Senator ALLARD. And—but it would be interesting, now, to look at this program, next year, to see if the more money that you put in there got spent wisely. And if they—and I would hope that, on these international agencies, that you expect accountability in taxpayer dollars when they go into them.

Secretary PAULSON. We do. We expect accountability, and there's also a point, on some of these things, that, if we want to be global leaders, and if we want to play the role that people would like us

to play at some of these multilateral organizations, that we have to put some money on the table. So, it's a tradeoff.

ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS

Senator ALLARD. Mr. Chairman, I have one more question, if you have time for that.

Would you like—let's see, on—the 2008 budget proposed creating an additional Assistant Secretary in the Office of International Affairs (OTA). Would you comment on why this is necessary, and what this position will be doing now that you're not currently doing?

Secretary PAULSON. Yes. This, to me, of all the things to defend, is the easiest. When I look at the role that I believe you should want Treasury to play in the world, and I look at the wide variety of issues that we're dealing with right now—you know, the strategic/economic dialogue with China; there's just a wide variety of things where we want to play a major role when we're dealing with our economic partners around the world—and if a man from Mars came down and looked at this in today's world and said, "They've got one assistant secretary in the international area," and then looked at the things that this man has on his plate, and the complexity of some of these issues, CFIUS being one of them, you know, the Committee on Foreign Investment——

Senator ALLARD. CFIUS?

Secretary PAULSON. Yes.

Senator ALLARD. The ports.

Secretary PAULSON. Yes. I would just simply say the level and the complexity of the issues we've got—Europe, Latin America, Asia—investment issues, trade issues—this is an important job. My Assistant Secretary for International right now is in Korea, helping Sue Schwab and her team with some investment provisions in an FTA they're trying to negotiate. It's a perfectly reasonable thing for him to be doing, but there's three or four other things he's not doing because he's there. And when I look at how other agencies are staffed, to me, this would be an important job to fill. And the interesting question, to me, is not why there's not two, it's why there's maybe not three. So, we went in, and have requested another assistant secretary.

Senator ALLARD. Well, thank you for your responses to my questions, and we'll follow up on the stuff on Internal Revenue on that hearing.

PART PROGRAM

I just—on all the—Mr. Chairman, on all these hearings that we have where we have the Secretaries show up who are in charge of the various Departments, I'm making an effort to sort of sensitize everybody to how important the PART Program is, because, as policymakers here on the congressional side, budget and appropriators, it's shedding information. And we get particularly concerned, I think, when we see something that's rated as ineffective. And if we—even worse yet, in my mind, is, we see an agency that is not demonstrating results, which, to me, lacks—shows a lack of effort.

Secretary PAULSON. Let me just make one additional comment. I do believe we should focus on performance, and we should have

to justify performance. One of the things I learned in the private sector, how you measure that performance and who actually measures the performance, makes the difference. And so, sometimes—and I'm not making any comment about PART or any other program, this is just a general observation. Some of the performance measurements that I've looked at are not worth the paper they're printed on. We will take responsibility. We know we need to answer to you, and to others, for performance, and, on any of these things, we're just happy to spend the time, and I'm not saying we're perfect——

Senator ALLARD. Yes.

Secretary PAULSON [continuing]. Because I found plenty of issues, but——

Senator ALLARD. Well, if that's the case, I'd hope you'd sit down with——

Secretary PAULSON. Right.

Senator ALLARD [continuing]. OMB and work that out.

Secretary PAULSON. Right. Right.

Senator ALLARD. Thank you.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator.

FINANCIAL REPORTING

Mr. Secretary, the Office of Foreign Assets Control and the Financial Crimes Enforcement Network have been overwhelmed by a backlog of financial reports filed by financial institutions, prompted by a desire to err on the side of caution.

Secretary PAULSON. Right.

Senator DURBIN. The result is said to be an abundance of filings reporting only nominally suspicious activity or transactions. First, is this the case? How would you characterize the magnitude of the backlog there? And what percentage of suspicious activity reports received are actually examined?

Secretary PAULSON. Well, let me say that this is an area where one thing I've learned to do is listen. As we look at competitiveness in the financial services industry, and capital market's competitiveness, one issue we need to look at is regulation, and, is there a cost benefit? You know, are we putting too many requirements under its institutions?

Senator DURBIN. So, what do you think?

Secretary PAULSON. This has been an area that has been cited, and it's one we're in the process of looking at right now.

Senator DURBIN. Can you explain to me——

Secretary PAULSON. I don't know what we have—sometimes if you build a haystack too big, you can't find the needle. And I'm not saying we've done that, but we've got a new head of FinCEN, we've got a very outstanding young man, and he's got his hands full. But this is one thing that we will be looking at, at Treasury, and, again, talking to others at the Fed and elsewhere.

IRAQ THREAT FINANCE CELL

Senator DURBIN. Can you explain to us what the Iraq threat finance cell is and how it's operating?

Secretary PAULSON. No, sir.

Senator DURBIN. I'll give you a chance to respond to that in writing, if you would, please.

Secretary PAULSON. Yes.

[The information follows:]

IRAQ THREAT FINANCE CELL

The Department of the Treasury broadened its unique intelligence role overseas through the Baghdad-based Iraq Threat Finance Cell (ITFC). Since its establishment in late 2005, the ITFC has paid significant dividends. Co-led by the Departments of the Treasury and Defense, the ITFC collects, analyzes, and disseminates timely and relevant financial intelligence to the war-fighter. U.S and Coalition military commanders have come to depend on this intelligence to help combat the Iraqi insurgency and disrupt terrorist, insurgent, and militia financial networks.

FINANCIAL REPORTING

Senator DURBIN. Some critics question whether U.S. economic sanctions and financial regulation, as you've just said, place too much burden on financial institutions and international banks without providing sufficient guidance and training to implement the measures in a cost-effective way. One estimate from 2003 suggested the annual cost of U.S. anti-money laundering efforts for businesses was upwards of $7 billion. Do you agree that U.S. counterterrorist financing efforts have placed too much burden on the private sector?

Secretary PAULSON. As I said to you, I thought I tried to answer the question, you know, the first time you asked it—which is that this is something we're looking at. There is a cost benefit. We need to get it right. Those activities are very important, they're critical to our national security. So, what we need to judge is, is there a way where we could reduce the burden and get a better, more effective result? Okay? Because——

Senator DURBIN. That's being studied now?

Secretary PAULSON. That's being studied now—because the goal is to stop terrorism, to stop illicit financial activities. And it's a very important goal. And these programs have been very successful. So, the question we're now asking is, what's the right balance? You've asked the question, and I obviously think it's a good question, because I've asked the question, myself, and we're looking at it.

Senator DURBIN. I always like it when——

Secretary PAULSON. We really don't have an answer yet.

Senator DURBIN. I always like it when my questions are complimented. Thank you.

SUDAN POLICY

Let me ask you another. You and I had a conversation in my office about Sudan and Darfur, and I expressed my concern about this situation which President Bush has, I think, accurately characterized as a genocide. We talked about things that we can do, as a Nation, to put pressure on Khartoum, the Sudanese Government, to allow U.N. peacekeepers to come in and provide a rescue effort for these poor people.

I'd like to ask you, if you can, to tell me what the Treasury Department of the United States can do to help in this situation. Can we block Sudanese transactions that flow through U.S. banks, so

that we can reduce the resources that the Sudanese Government can bring to bear against its own people? And what resources would you need to accomplish that, if possible?

Secretary PAULSON. Well, let me say, as you mentioned, we had a chance to talk about this. I've talked with the President a number of times about this. As you know, he's very committed and very passionate; talked with Secretary Rice, as she and Special Envoy Natsios are leading the efforts, Treasury is playing a support role, and, I believe, an important support role. We've had sanctions in place since 1997. You've identified one of the things we can do, which is to identify and disrupt dollar payments to Sudapet or other entities in Sudan, particularly those that go through the U.S. financial system. I think you will see, sometime in the weeks and months ahead, some actions taken that will show you that we're being active and diligent. I press people all the time, as does the President, to be creative, to think out of the box.

I know one thing we would like, and we're thinking it through, and we'll have some legislative suggestions. But right now, if we find a financing that is going through the U.S. banking system, we'd like the flexibility to charge a larger fine, because $50,000 per transaction may not be enough, when you run into a major transaction.

And so, there will be some things. And I do think this is one area, Mr. Chairman, where, knowing your commitment, we've had people up, briefing you, as much as you want to talk to our people. We're committed. If you've got ideas, we want to explore them and work with you, because this is very important.

Senator DURBIN. We had a classified briefing with Special Envoy Natsios just last week.

Secretary PAULSON. Yes.

Senator DURBIN. And we're working with him, and I won't go any further in my statements at this hearing, but if the Treasury Department needs additional resources at any point, we want to be there to help.

Secretary PAULSON. Right. And I think Treasury might have been there when you had that——

Senator DURBIN. Yes, I believe you were.

Secretary PAULSON. We had people there, so——

ECONOMY AND WAGES

Senator DURBIN. I'd like to ask you some general questions about the economy, because I think you have a unique perspective, having come from the private sector, now in the administration, dealing with some of the policy decisions that are being made. Our economy has clearly grown over the last several years, but there is ample evidence that the benefits of this growth have not been spread evenly across our population. Income inequality has been rising. Wages are not keeping up with productivity. And many families feel like they're being left behind. What do you think we should do to ensure that Americans benefit from the growth of our economy?

Secretary PAULSON. I think that is an important question, and one that I'm focused on. I would say this. When I came here, in July, and looked at the numbers—and, as a matter of fact, the first

time I spoke on the economy, I talked about this issue—and it was my best judgment then that this was a time very much like the mid-1990s, and that if we kept adding new jobs and the top line stayed strong and productivity remained high, you would see that start to translate itself into real income growth for the average worker. And we've seen some real tangible signs of that. So, real income is now up 2 percent over last year. So, there's some positive movement.

But to get to your fundamental question, and the fundamental question really is that in this country, and in many other countries around the world, there's been a trend, that now goes back for almost three decades, which is the widening divergence between the top and the bottom. And there are different theories about this. Some people point to trade. I really believe that, by far, the biggest driver is technology and that what we're seeing—and there's been very, very major changes in productivity increases as a result of technology—and those people that are able to use technology and leverage themselves through technology, and have the skills that are most in demand, are getting the greatest benefits. So, I've got to believe that there are ways to do a better job than we, as a Nation, are doing. And I know this is something the President's talked about. It's education, but, more than education, longer-term education, it's training and skill development. And so, I do think, as I travel around the world and talk with people in other industrial nations, they're all focused on the same things.

HOUSING MARKET

Senator DURBIN. Could I ask you about a specific issue that came up last week in hearings on the Hill? It relates to the basic desire of people to own a home, and people with limited financial resources get involved in some pretty risky borrowing with the subprime lending——

Secretary PAULSON. Right.

Senator DURBIN [continuing]. To buy—to build a home, and some of them guessed wrong, they weren't able to keep up with the payments and now have been overwhelmed by the situation. The banks are unhappy, the consumers, the homeowners are unhappy, and a lot of us in the Senate are unhappy when we hear from them.

What's your view on the volatility in the subprime lending market? And how much impact do you think this'll have on our economy, as a whole? And can the Treasury do anything to address this issue?

Secretary PAULSON. I'll take a few minutes on this one, because it's very important, and, in some ways, it's complicated.

But let's begin with the fact that we are making—and I believe it will be a successful transition, but a transition from an economy that was growing at an unsustainable level to one that's going to be growing at a more sustainable level. There are a number of positive signs. Inflation seems to be relatively contained. The labor market remains strong. We've had exports growing faster than imports for four quarters now. And the consumer is hanging in there. But there's been a major correction in housing. And, of course, housing was growing at a level way above what was sustainable,

for a number of years. And it's quite a significant correction. And it has impacted a lot of people.

It would appear to me that the housing—because you're dealing with the systemic impact on the economy—that it would appear that the housing correction is at the bottom, or near the bottom. We need to watch it longer, but that's what it would appear. It is then not surprising, as regrettable as it is, that you would have the issue with subprime mortgages and other mortgage resets. And this will take longer to work its way through the system.

Looking at it from a systemic standpoint—again, I'm going to get to the human situation in a minute, but from the systemic standpoint, my best judgment is that this is largely contained. And, in terms of people that have been impacted, it has to be a grave concern, and we need balance. I think, the understanding of the balance, that access to credit and credit availability made homeownership available to a good number of people, and we need to get that balance right. At Treasury, we're looking at it from the systemic standpoint and the impact on the economy, but we're also asking ourselves other questions, and we have a process going where we're talking with the Federal regulators and other regulators at the State level, and that you know, the regulatory structure is something that we're looking at, at Treasury, as it relates to financial market's competitiveness. We have a Balkanized regulatory structure, and, in a number of areas, we have multiple regulators sometimes competing with each other, and, in others, there seem to be some holes where there isn't as much regulation. So, we're looking at it from the consumer protection standpoint, predatory lending issues, fraud issues, and those sorts of things, and lessons learned.

But, again, I just want to emphasize, we want to take a careful, thoughtful look at this, and we don't want to rush to judgment or overreact, because, again, the availability of credit has been very important to millions of Americans.

FINANCIAL CREDIT

Senator DURBIN. I'd like to follow up on that. In my lifetime, and in yours, we have gone from an environment of usury laws to payday loans——

Secretary PAULSON. Yes.

Senator DURBIN [continuing]. From one extreme to the other.

Secretary PAULSON. Yes.

Senator DURBIN. And it strikes me that we do need some balance here. We want to make credit available, but I think there is credit exploitation taking place now. And I picked on payday loans, because, in my State, that—our State—that's the obvious place to go. But I also think it relates to credit cards and relates to a lot of credit that's now being extended to people, beyond their means, without real notification of the danger that they are courting if they're not careful. So, I hope, when you look at this, you will look at both sides of the equation, not only the availability of credit, but the abuse of credit by some institutions, at this point.

Secretary PAULSON. You're totally right. And as with everything in life, it's balance. It's like the question you were asking me about the anti-money laundering laws, Do we have the right balance? And that's the key question here.

DIALOGUE WITH CHINA

Senator DURBIN. I want to ask you—last question—about China, because you've shown an interest in China, and I've been watching your efforts to the strategic/economic dialogue over the past month. I thank you for bringing this issue to the fore. And obviously we have some concerns at Capitol Hill, and at home, and about whether the Chinese will float their currency soon. Will they shut down the rampant intellectual property theft that we know has robbed many American businesses of untold revenue? Will they enforce better labor, environmental, and human rights standards? And what steps is the administration taking to move in these directions?

Secretary PAULSON. Well, thank you for asking that question. This is a major focus of mine, and I think, as you know what we're doing through the strategic economic dialogue is getting all the agencies, departments in the U.S. Government that deal with economic issues to come together, prioritize, and speak with one voice to the highest levels of the Chinese Government.

Now, let me take two issues you mentioned, because we're dealing with longer-term structural issues in the dialogue, but we also are dealing with the pressing short-term issues, which need to be solved. Take currency as an example. The renminbi, clearly we need more flexibility and we need more appreciation in the short term, and we're pushing very hard, and that's important, in our country—and, frankly, it's important in their country if their market's going to develop in a way in which it's going to be good for them and good for us. But we also need to get to the point where they can have a market-determined currency, because many countries in the world have managed currencies, many of them don't have market-determined currencies. But China is, by far, the largest that doesn't have a currency whose value is set in a competitive marketplace. And so, they're in this situation where they're a big part of the global economy, they're integrated into the global economy, in terms of trade and products and services, but their financial markets are very, very immature, they are not integrated into the markets. And so, a big part of what I need to do, and what I have been doing—and I was, matter of fact, in Shanghai several weeks ago, giving a speech on the need to reform their capital markets and open up to competition, because only when they do that are they going to be able to get to the point where we all want them to get, where they have a currency that trades in a competitive marketplace. And then, the other benefit is that right now they have a savings rate at a precautionary level, at 50 percent. And why do their individuals save at such a high level? Well, frankly, because they are not getting any reasonable return on their savings.

There's over $2 trillion in Chinese banks earning 2½ percent, which is negative after taxes and after inflation. And when you look at what we can get as a return in a savings plan, a pension fund in the United States or other industrialized nations that are growing at much lower levels than China, and you translate and say, if Chinese savers in their pension plans were able to get 8 percent, then we would have the kind of economy they'd like to have

and the kind of economy we would have. And that's really going to be the only way we're going to be able to satisfactorily address the trade balance program.

Now, on intellectual property, you're right, a very sensitive issue. This is something that is handled by USTR and Commerce through the JCCT. I do everything I can to help out, and we deal with that negotiating and also through the World Trade Organization (WTO) which has ways of resolving disputes, and so, we have a number of ways to go about trying to enforce proper laws, and this is quite important.

PRIVATE CAPITAL

Senator DURBIN. I said that was the last question. It turns out there's one I really have to go to, because it is important, and I hope you'll forgive me for one more question. And it's in an area that is a complex area. But the President's working group recently released principles and guidelines on private pools of capital.

Secretary PAULSON. Right.

Senator DURBIN. This principle-based framework generally relies on market discipline to strengthen investor protection and guard against systemic risk. Do you consider this a first step toward addressing the challenges presented by the growth of hedge funds? And, if so, what additional steps are being considered? And what evidence is there that this indirect approach to hedge-fund supervision is more effective than direct approaches, such as those employed by the United Kingdom Financial Services Authority, in protecting investors and mitigating systemic risk?

Secretary PAULSON. Well, again, that's a big important question, and let me do my best to answer it in a few minutes.

First of all, there is no doubt that the global capital markets have changed significantly over the last 5 years, in particular. And there has been a big growth in private pools of capital, which are often referred to as hedge funds or private equity funds. And there's been a big increase in over-the-counter derivatives, as opposed to exchange-traded derivatives.

As we've studied this at the President's working group, we've all concluded that, by and large, these are positive developments. They've helped disperse risk, make the markets more competitive and more efficient. But they're not without challenges. And so, we've thought about it very carefully, and, as we addressed it, what we came out of our deliberations with was something which I thought was quite important, because we had members of the President's working group and other important regulators, like the OCC, all come together and, with one voice, say, "This is how we want to deal with this." And the focus was really in two areas—first of all, is systemic risk, managing systemic risk. And here, there is quite a proactive focus in dealing with the regulated entities—the banks, the prime brokers, and others that lend money and provide credit—and making sure that there is the proper liquidity, its transparency, all of those sorts of things. And then, on the investor protection end, the Securities and Exchange Commission's (SEC) obviously got a big role to play, in terms of their antifraud, and in terms of the threshold levels for investors to come

into these funds. And, again, there is a big emphasis on transparency.

Now, it is our view that—to have all of the regulators come together and, with a principles-based approach, emphasizing market discipline, and all speaking with one voice, would be a major development. And we're going to watch this, continue to study it, see how things develop.

There's also a good deal of work that is really being coordinated under Tim Geitner, at the New York Fed, dealing with derivatives. And, again, they're dealing with a lot of the settlement issues, clearing settlement, the infrastructure issues, making sure that there are contracts that work in times of stress, that sort of thing. So, there's a lot of work being done in all of these areas, and we're going to continue to look at them.

Senator DURBIN. I'm sure that you remember the collapse of the Long Term Capital Management Group.

Secretary PAULSON. Yes.

RISK MANAGEMENT

Senator DURBIN. The President's working group released a report that contained a number of recommendations for improving risk management practices at the financial institutions that conduct transactions with hedge funds. What evidence is there that these recommendations have been implemented and that such implementation has reduced systemic risk from hedge-fund activity?

Secretary PAULSON. Well, again, that's a complicated question. Just as an observation, I'm not going to say there's a cause and effect—but we haven't had a financial shock since 1998. So, we need to go back to long-term capital.

I do believe, as someone who was in the financial sector when these recommendations came out, they made a difference. People looked at them. I think that there are real benefits, but there are challenges. And I think what we came out with—I was really gratified that we had all of the regulators, in the United States—the Federal regulators—come together with a forward-leaning approach, and we're going to watch this very carefully, and keep looking, and, if other steps need to be taken, we will recommend them.

SARBANES-OXLEY REQUIREMENTS

Senator DURBIN. Last question, for sure. Sarbanes-Oxley. Some of our mutual friends, in Chicago and other places, tell me it just goes too far, too darn many requirements, too expensive, discourages people from serving on corporate board of directors. And some of our other friends, mutual friends, say, "Thank goodness for Sarbanes-Oxley"—restored the integrity of our corporate structures after the scandals of Enron and other companies, and were it not for that integrity, we would just be another competitor in the global scene. We have a primacy, because we do have tougher requirements, and people know there's transparency and accountability. So, where does Secretary Paulson come down on Sarbanes-Oxley?

Secretary PAULSON. Well, let me say that I've given a very long speech on the topic, which is probably too long for you to hear today. We had a Capital Markets Competitiveness Conference the other day, which was, I believe, quite successful. We will have fol-

low-up on things we're going to do in three areas, but I'm going to try to summarize some of my thoughts for you. But, again, it'll be very similar to what we've said in some other things, that it's a matter of balance.

Now, if you look specifically at the Sarbanes-Oxley legislation, I don't see—and I don't think—there have been a number of groups that studied it, and I think they've all concluded the same thing—it doesn't take a legislative fix. There are very good principles in that legislation, and, matter of fact, some of the abuses that have taken place, really, most of them were before that legislation, as it related to some of the abuses in the options areas and others. So, I think when people talk about Sarbanes-Oxley, they're using that as a shorthand for not just the law, but the implementation of the law, and the regulatory and enforcement environment, and the legal environment, and the fact that because the corporate scandals were accounting scandals, for the most part, and there were, then significant reforms, that there are also a number of ways in which the relationship between accountants and boards have changed, all of which are not constructive. And so, the question is now not, are there some issues? Because there are some issues. The question is what to do about it. And a lot of it is balance, a lot of it is taking a risk-based approach, looking at the cost and the benefits, and not saying, "We want to regulate—that if we regulate to a large extent, we can eliminate losses or what have you."

So, we will be coming out with some ideas that deal with, first of all, regulatory structure, and, what are the issues surrounding regulatory structure in the United States? We'll be coming out with some steps that might be taken and thoughts we have in the accounting area. A very important step has already been led by Chairman Cox and Chairman Olson, of the SEC and PCAOB, on the way in which something that's called section 404 of Sarbanes-Oxley is implemented, which is a very simple provision of the bill, but has to do with an accounting standard relating to control systems, and it's a place where implementation was very flawed, the cost-benefit equation got way out of balance, and it's got to be put back in balance.

So, there are the accounting issues that we'll look at, and then look at the enforcement in the legal environment. But, again, I think, often when people talk about Sarbanes-Oxley, they don't really mean the bill, because if you say, "Now, tell me, what specifically would you change in the bill?"—what they talk about is, there's been so much change that happened in such a short period of time that everyone in the private sector is still trying to digest that change and get it in the proper balance.

Senator DURBIN. Mr. Secretary, thank you for your patience. I'm sorry we got started so late.

I want to thank all those who participated in preparing for this hearing. I appreciate the benefit of hearing from you about the Department. I think this forum has provided us some insight into the Department's operations, which will help us in our budgetary considerations.

ADDITIONAL COMMITTEE QUESTIONS

The hearing record will remain open for a period of 1 week, until Wednesday, April 4, at noon, for subcommittee members to submit statements and their questions for the record.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

ALTERNATIVE TO OUTSOURCING: FEDSOURCE—STAY AT TREASURY OR MOVE TO GSA?

Question. Franchise Funds were established by Congress under the Government Management Reform Act of 1994 to foster competition and creativity in government. "FedSource" operates under the franchise granted to the Treasury Department to provide business services to federal agencies on a competitive, cost-reimbursable basis. It has been reported that the Treasury Department may transfer this ability to the General Services Administration or Defense Logistics Agency.

Mr. Secretary, can you explain to me why you are thinking about relinquishing this program and the potential timetable for doing so?

Answer. The Treasury Department strongly supports Franchise Funds as a means of fostering competition in government. Treasury's Franchise Fund components will continue to offer administrative services such as travel, procurement, personnel and accounting. Only one component, FedSource, is affected.

The Treasury Department will transition out of the interagency acquisition business operated by FedSource for two primary reasons:

—The original purpose of FedSource was to provide small-scale and limited acquisition support, which met the Treasury Department's strategic needs at the time of its creation. However, the significant increase in activity related to customer demand has required an increase in operational commitment that is not compatible with the core mission and focus of the Department. Treasury management, both at the Department and at the Bureau of the Public Debt, has significant concerns with the risks associated with sustaining the current business model. In addition, recent reports by the Treasury Inspector General and the Defense Department Inspector General identified control weaknesses and procurement deficiencies.

—Other government organizations (e.g., the General Services Administration and Defense Logistics Agency) whose core missions include providing these types of procurement services may be better positioned to provide these services at the best value to taxpayers.

The Treasury Department will ensure a smooth and orderly transition process. The goal is to complete the transition, which will be managed by the Bureau of the Public Debt, by September 30, 2008.

The Treasury Department is committed to protecting taxpayer resources, quickly addressing management issues, and operating the Department in the most efficient and effective way possible.

Question. For the 10th consecutive year, certain material weaknesses in financial reporting and other limitations on the scope of its work resulted in conditions that prevented GAO from expressing an opinion on the federal government's consolidated financial statements. A major factor contributing to the GAO's disclaimer is the federal government's ineffective process for preparing the consolidated financial statements. As reported by GAO, such weaknesses in the consolidated financial statements preparation process impair the U.S. government's ability to ensure that these statements were (1) consistent with the underlying audited agency financial statements, (2) balanced, and (3) in conformity with U.S. generally accepted accounting principles.

Although Treasury has made progress in addressing some of these identified weaknesses, what more can be done to timely resolve such problems so that this area is no longer a major impediment to the federal government receiving an opinion on its consolidated financial statements?

Answer. Each year Treasury, through the Financial Management Service (FMS), continues to improve its policies, procedures, information systems and internal controls used to prepare the government-wide consolidated financial statements (formally the Financial Report of the United States Government or FR) and will continue to do so. During the fiscal year 2006 audit, FMS' efforts resulted in the resolution of approximately 60 GAO recommendations. FMS will continue to resolve the

preparation issues that are in our realm of control. However, there are other preparation data integrity issues that depend on accurate and consistent data being submitted by the agencies.

FMS is working diligently on providing the agencies with guidance, tools, and assistance to improve the accuracy and consistency of the agency data to the point where the issues identified by GAO are mitigated or resolved at the FR preparation level. The following discussion provides FMS' planned actions to address those recommendations, as well as the initiatives that FMS is implementing to help the agencies improve their data accuracy and consistency.

Consistency with agency audited financial statements

FMS currently uses the Government-wide Financial Reporting System (GFRS) as the principal information system to collect agency audited financial statement information and produce significant portions of the FR.

In fiscal year 2006, GAO acknowledged and noted improvements with regard to consistency with agency information in the Balance Sheet, in the Statement of Net Cost and Statement of Social Insurance, and in the note disclosures that are directly linked to the amounts on these principal financial statements. FMS is currently revising its policies in fiscal year 2007 to ensure that the remaining notes are materially traceable to agency note disclosures.

FMS has two major initiatives which will modernize longstanding Federal accounting processes and provide agencies with methodologies and tools to improve the accuracy and consistency of their financial data:

—The Government-wide Accounting (GWA) Modernization project which will replace existing government-wide accounting functions and processes. This project will improve the reliability, usefulness, and timeliness of the government's financial information, provide agencies and other users with better access to that information, and will eliminate duplicate reporting and reconciliation burdens by agencies, resulting in significant government-wide savings. It will also improve the budgetary information being collected from the agencies at the transaction level.

—The Financial Information and Reporting Standardization (FIRST) initiative integrates budget and financial reports from Federal Program Agencies. FIRST will improve the consistency of the budgetary and proprietary accounting data recorded in agency financial statements and reported to FMS through its trial balance.

Balanced Consolidated Financial Statements

A major challenge in preparing balanced financial statements is properly accounting for and eliminating unreconciled intra-governmental transactions. Some of these transactions occur solely between two federal agencies while others occur between the agencies and the general fund. FMS is taking the following actions to address this issue:

—Requiring comprehensive intragovernmental accounting data from agencies on a quarterly basis that will allow FMS to provide data to all federal agencies for them to better analyze and reconcile intragovernmental differences.

—Working with the CFO Council and OMB to enforce the business rules for intragovernmental transactions and to organize the Dispute Resolution Committee.

—Encouraging greater auditor participation by requiring agency auditors to more closely scrutinize intra-governmental out-of-balance conditions with other agencies.

—Moving forward on the FIRST initiative which is being designed to provide authoritative information contained in Treasury's central accounting system to the agencies to facilitate the reconciliation process for specific intra-governmental transactions.

Compliance with GAAP

During fiscal year 2006, FMS made significant improvements in improving overall GAAP compliance. FMS was able to significantly reduce the number of audit findings relative to GAAP compliance. For fiscal year 2007, FMS will

—Use the Chief Financial Officers (CFO) Council, Central Agency Reporting Subcommittee as a forum to discuss those accounting and reporting issues that affect the FR.

—Focus on the remaining material items with the expectation that the findings related to these items can be closed by GAO either this year or next year.

—Continue to revise and update the Treasury Financial Manual with accounting, reporting, and disclosure policies and procedures to ensure compliance of the FR with generally accepted accounting principles (GAAP).

Question. TFI is home to the newest addition to the U.S. intelligence community: the Office of Intelligence and Analysis (OIA).

How well is the office being integrated into the intelligence community?

How would you characterize the degree of intelligence sharing that takes place between Treasury and the rest of the intelligence community?

Do any barriers to intelligence sharing exist?

Answer. Since the creation of the Treasury's Office of Intelligence and Analysis (OIA) under the Intelligence Authorization Act of Fiscal Year 2004, it continues to build relations throughout the Intelligence Community (IC). In particular, OIA has developed important partnerships within the leadership of the IC, through collaborative projects, information sharing, and community support.

Even though OIA is one of the newest and smallest intelligence elements in the IC, it participates on key IC committees. On April 9, 2007, Director of National Intelligence (DNI) McConnell created an Executive Committee to serve as the principal decision-making and advisory board for the IC. Treasury's Assistant Secretary for Intelligence and Analysis, who manages OIA, was designated a member of that committee. In addition, the Deputy Assistant Secretary for Intelligence and Analysis and OIA's policy staff have been involved in ODNI boards and committees that have been responsible for setting policy for the IC, standards of analysis, and driving change in the IC culture.

Through exchanges and detail assignments at the working level, OIA has built strong relationships with IC counterparts. Since OIA was created, it has hosted representatives from the Federal Bureau of Investigation (FBI), National Security Agency (NSA), the United States Central Command (CENTCOM), the Joint Warfare Analysis Center (JWAC), and other key intelligence partners. Moreover, OIA has detailed analysts to CENTCOM, the United States Pacific Command (PACOM), and the United States European Command (EUCOM). The 2008 President's budget request includes increased resources to expand OIA's detail assignments.

A good example of how well OIA has integrated into the IC, as well as the high degree of intelligence sharing, is found in Treasury's Weapons of Mass Destruction (WMD) proliferation program. In order to work on targeting and researching potential targets for Treasury sanctions against WMD proliferators under Executive Order 13382, the Defense Intelligence Agency (DIA), with the assistance of the Director of National Intelligence, detailed several analysts to OIA. The DIA analysts have helped to expand and accelerate Treasury's activities on this program.

A key element to OIA's integration into the IC is the ability to send and receive information relevant to Treasury's mission. Primarily a consumer of information, OIA has regular access to the intelligence it requires to prepare administrative records in support of targeted financial measures against terrorist supporters. While OIA produces very little raw information, it is producing both analytic cables and finished analytical products for dissemination to the IC. To aid the dissemination of those products, OIA has developed a Top Secret/Sensitive Compartmented Information (SCI) website that can be accessed by partners throughout the IC. Internally, OIA has access to Top Secret/Sensitive Compartmented Information (SCI) through the Treasury Foreign Intelligence Network (TFIN), an information technology system that is being redesigned and updated in fiscal year 2007.

While OIA has made significant progress integrating itself into the culture of the IC, working to be a full partner in the intelligence enterprise, there are still some barriers that result from a continuing lack of understanding in other IC elements about OIA's IC role and expertise. As other IC components, however, become more familiar with OIA, this limiting factor will become less of an issue.

Question. It has been asserted that OIA is primarily reactive, analyzing information that is provided to TFI by U.S. and other financial institutions.

Is TFI able to initiate or influence intelligence collection priorities?

Answer. Treasury's Office of Intelligence and Analysis (OIA) is a member of the Intelligence Community (IC) and provides all-source analysis, derived from intelligence, law enforcement, regulatory, and open sources, to Treasury and IC customers. As an IC member, OIA is able to ensure that its intelligence needs are met through the intelligence requirements process. In particular, OIA's involvement in national requirements mechanisms is enhanced by experienced analysts initiating and contributing to tactical requirements.

National Requirements

In 2005, OIA achieved a significant milestone by hiring a dedicated collection requirements officer. This officer has ensured that Treasury equities in financial, economic, enforcement, and other information needs are reflected in national intelligence priorities and collection requirements. Among the various national bodies with which OIA engages include the U.S. SIGINT Committee and its Analysis and

Production Subcommittee, the Community HUMINT Management Office, the National HUMINT Requirements Tasking Center, various National Clandestine Services offices, the Open Source Center, and various CIA Directorate of Intelligence offices. In addition, OIA's subject matter experts work closely with the Director of National Intelligence's (DNI) Mission Managers, particularly those at NCTC, NCPC, Iran, and North Korea, to ensure Treasury priorities are incorporated into national collection and analysis strategies for these hard targets.

Tactical Requirements

OIA analysts actively provide feedback and direction on disseminated intelligence reports to ensure that information relevant to Treasury's mission is collected. Critical partnerships developed by Treasury in the last few years have enhanced this process. OIA analysts regularly engage with counterparts in collecting offices across the IC. Detail assignments and exchanges are particularly useful for communicating Treasury needs and priorities to partner agencies. OIA, for example, hosts several detailees from NSA to assist with its SIGINT collection needs. Another example is the Iraq Threat Finance Cell (ITFC) in Baghdad, which OIA co-founded and co-leads. The ITFC has worked diligently to increase the quantity and quality of reporting on terrorist and insurgent financing in Iraq, with considerable success.

Question. Treasury has recently completed an initial study of the feasibility of mandating financial institutions to report cross-border wire transfer data. The study concluded that such reporting is technically feasible and might prove valuable in combating money laundering and terrorist financing. The report also noted that the proposed program could result in the filing of half a billion new financial reports by financial institutions.

Given the additional costs that this might impose on the financial sector, do you believe mandating the reporting of cross-border wire transfer data is necessary and desirable?

Answer. The Intelligence Reform and Terrorism Prevention Act of 2004 contained two mandates related to the potential collection of cross-border electronic funds transfer reports. First, the Act directed that the Department study the feasibility of implementing a system to receive, store, process, analyze, disseminate, and secure such data. Second, the Act directed the Department to implement such a system if the Secretary deemed it "reasonably necessary."

In its study, FinCEN concluded that the implementation of such a system is, indeed, feasible. FinCEN also identified a number of important policy questions that must be considered before the Department of the Treasury can make a final determination whether such a requirement is reasonably necessary. One of the primary concerns is the potential cost to the financial services industry. Therefore, FinCEN proposed conducting an additional cost-benefit analysis to support a final decision by the Secretary whether such a requirement is reasonably necessary. This cost-benefit analysis will directly address the potential costs to the financial services industry, and the potential value of the data to U.S. government efforts to combat illicit financing. Only after assessing these issues will the Department be able to reach a conclusion about whether mandating the reporting of such data is necessary and desirable.

As part of the study FinCEN will:

—explore the potential, but as yet unquantified, risks to the operations and competitiveness of the U.S. financial services industry;

—further refine the use cases and requirements of our law enforcement and regulatory partners, which FinCEN describes in its Study; and

—extend the preliminary assessment of the potential value of such data in our collective efforts to combat illicit financial activity.

Question. Recent U.S. Executive Orders and the USA PATRIOT Act gave Treasury a greatly expanded tool-kit to combat terrorist financing. Subsequently, many of these measures have been used to curtail the international financial operations of rogue states such as Iran and North Korea.

Can these measures be used more aggressively against non-state terrorist organizations? What operational challenges might you face?

Please discuss how Treasury's use of its new authorities is viewed internationally, especially among our allies. Is getting foreign countries and companies to cooperate with U.S. measures a problem?

Answer. The Department of the Treasury is acting aggressively against non-state terrorist organizations. We actively target al Qaida-related and Hizballah-related organizations under our relevant Executive Orders. Additionally, Treasury continues its effort to increase financial pressure on Hamas. A few examples of Treasury's recent activity utilizing our expanded tool-kit to combat terrorist financing include:

—On February 20, 2007, Treasury designated Jihad al-Bina, a Lebanon-based construction company formed and operated by Hizballlah. Jihad al-Bina receives direct funding from Iran, is run by Hizballah members, and is overseen by Hizballah's Shura Council, at the head of which sits Hizballah Secretary General Hassan Nasrallah.

—On January 26, 2007, Treasury designated two South African individuals, Farhad Ahmed Dockrat and Junaid Ismail Dockrat, and a related entity for financing and facilitating al Qaida, pursuant to Executive Order 13224. This financial measure freezes any assets the designees have under U.S. jurisdiction and prohibits transactions between U.S. persons and the designees.

—On December 6, 2006, Treasury designated nine individuals and two entities that have provided financial and logistical support to the Hizballah terrorist organization. The designees are located in the Tri-Border Area (TBA) of Argentina, Brazil, and Paraguay and have provided financial and other services for Specially Designated Global Terrorist (SDGT) Assad Ahmad Barakat, who was previously designated in June 2004 for his support to Hizballah leadership.

These designations, among many others, highlight Treasury's use of authorities granted by U.S. Executive Orders.

Treasury's actions are most effective when other nations amplify our designations with their own measures. Thus, the most significant operational challenge has been when other states have not implemented remedial actions against designated targets. Treasury is working to address this issue through a variety of mechanisms, among them, the U.S.-EU Terrorism Finance Troika and the U.S.-EU Workshop on Financial Sanctions to Combat Terrorism. Treasury has also worked with USUN and other elements at the United Nations to advocate for the adoption of U.N. Security Council Resolutions aimed at combating terrorist financing. For example, UNSCR 1735, adopted in December 2006, is a follow-on resolution to UNSCR 1267 and it reiterates the international community's condemnation of al Qaida, Osama bin Laden and the Taliban, as well as the international commitment to countering terrorism and terrorist financing via measures that include a targeted economic sanctions regime (e.g., asset freeze and ongoing prohibition of commercial and economic dealings), a travel ban, and a ban on the sale or supply of arms and related material. Additionally, Treasury works with the Financial Action Task Force (FATF) to establish standards and commitments on targeted financial and economic measures that form a framework for multilateral action and cooperation in the fight against illicit financing. These efforts are bolstered through our work with the G–7, the International Monetary Fund (IMF), the World Bank, and FATF-Style Regional Bodies (FSRB).

Acting multilaterally and working with various foreign governments and international organizations and companies to increase the effect of our actions are high priorities of the Treasury Department. Treasury has initiated strategic dialogues with all relevant parties of the international community and we enjoy great success and continued cooperation. Generally, foreign countries and private companies are eager to abide by and cooperate with U.S. authorities. Recently we have seen many international financial institutions implement their own measures to protect themselves from deceptive conduct without waiting for their governments to impose specific requirements and regulations.

COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES

Question. The Committee on Foreign Investment in the United States is an interagency committee chaired by the Secretary of Treasury. CFIUS (SIF–EUS) seeks to serve U.S. investment policy through thorough reviews that protect national security while maintaining the credibility of our open investment policy and preserving the confidence of foreign investors here and of U.S. investors abroad that they will not be subject to retaliatory discrimination.

Can you explain briefly to the Committee why the Committee on Foreign Investment in the United States (CFIUS) was established? What is its purpose?

In your opinion, how well is it doing at achieving its purpose?

What changes have been made in the operations of CFIUS during the past year?

Who are the members of CFIUS?

What role does the Director of National Intelligence play in the CFIUS process?

As you know, the House recently passed legislation aimed at enhancing Congressional oversight of the CFIUS review process. What is the Department's position on that bill?

Answer. CFIUS was established by Executive Order 11858 in 1975. The Secretary of the Treasury was designated as the chairman of CFIUS. Its original mission was to have primary continuing responsibility within the Executive Branch for moni-

toring the impact of foreign investment in the United States, both direct and portfolio, and for coordinating the implementation of U.S. policy on such investment.

In 1988, the President, pursuant to Executive Order 12661, delegated to CFIUS his responsibilities under section 721 of the Defense Production Act of 1950 ("Exon-Florio" amendment) to receive notices of foreign mergers and acquisitions of U.S. companies, to determine whether a particular acquisition has national security issues sufficient to warrant an investigation, and to undertake an investigation, if necessary, under the Exon-Florio provision. In addition, it allows the President to take action, if necessary, to suspend or prohibit any transaction that, in his judgment, threatens the national security.

In essence, the purpose of CFIUS is to protect national security while keeping our country open to investment, which is critical to a strong U.S. economy.

In the past 20 years, CFIUS has investigated over 1,700 cases. To the best of our knowledge, the CFIUS agencies have implemented Exon-Florio in a manner that has achieved the national security objectives as prescribed in the statute without compromising our open investment policy. Investigations are conducted by analysts with expertise from across the agencies in a professional and non-partisan manner.

CFIUS has already implemented many of the reforms proposed by Congress. These include, among others:

—*Notification*.—We now inform the relevant congressional committees of every case once deliberative action has concluded under Exon-Florio.

—*Briefings*.—We are providing periodic briefings to Congressional oversight committees on all cases once deliberative action has concluded.

—*Accountability*.—At Treasury, every case is briefed to senior policy levels, and only Senate-confirmed officials may close a CFIUS review.

—*Role of the DNI*.—We have formalized the role of the intelligence community by having the Office of the Director of National Intelligence serve as advisor to CFIUS, facilitating a coordinated analysis of each case by the intelligence community.

CFIUS includes six departments and six White House agencies. Specifically, the members of CFIUS are the Departments of Treasury, State, Defense, Justice, Commerce, and Homeland Security, as well as the Office of Management and Budget, the Council of Economic Advisers, the U.S. Trade Representative, the Office of Science and Technology Policy, the National Security Council and the National Economic Council. Other agencies, such as the Departments of Energy or Transportation, may be brought in when specific expertise is required in the investigation of a transaction.

The Office of the Director of National Intelligence has a non-policy role as advisor to CFIUS, facilitating a coordinated analysis of each case by the intelligence community.

The Administration's position on H.R. 556 is provided in the Statement of Administration Policy (SAP) submitted to the House on February 27, 2007, which we attach to these responses. In sum, the Administration regards national security as its top priority and supports the intent of the House bill to address national security imperatives in a post-9/11 world. We support enactment of legislation that will improve and strengthen CFIUS to ensure the protection of America's homeland and the strength of the U.S. economy. The SAP lays out the Administration's concerns about several provisions of the bill.

EXECUTIVE OFFICE OF THE PRESIDENT,
OFFICE OF MANAGEMENT AND BUDGET,
Washington, DC, February 27, 2007.

(HOUSE RULES)

STATEMENT OF ADMINISTRATION POLICY

H.R. 556—NATIONAL SECURITY FOREIGN INVESTMENT REFORM AND STRENGTHENED TRANSPARENCY

(REP. MALONEY (D) NY AND 58 COSPONSORS)

The Administration supports House passage of H.R. 556 and appreciates the efforts of the House Financial Services Committee to strengthen the Committee on Foreign Investment in the United States (CFIUS). The Administration regards the Nation's security as its top priority. In addition, the Administration views investment, including investment from overseas, as vital to continued economic growth, job creation, and building an ever-stronger America. Therefore, the Administration seeks to improve the CFIUS process in a manner that protects national security and

ensures a strong U.S. economy and an open investment environment that will serve as an example and thereby support U.S. investment abroad.

In light of the President's responsibility to ensure the Nation's security, and in the context of comity between the executive and legislative branches, we believe the President should retain substantial flexibility to determine CFIUS's membership and administrative procedures and to make adjustments when national security so requires. Accordingly, the Administration has concerns with some of the provisions of H.R. 556 and looks forward to working with Congress to address these concerns, to strengthen CFIUS, and to ensure the protection of America's homeland and the strength of our economy.

Establishment and Membership of CFIUS

The President should retain the flexibility to determine and adjust the appropriate Executive Branch membership of CFIUS and their roles. H.R. 556 should not mandate that CFIUS have Vice Chairs, nor that CFIUS include members of the Executive Office of the President. Further, the President should retain the flexibility to determine roles and responsibilities of CFIUS and its members. For example, the Administration opposes any language in Section 6 that would call for the designation of a lead agency or agencies to represent other agencies or the Committee in negotiating, entering into, imposing, modifying, monitoring, or enforcing mitigation agreements.

Deliberations and Decision-Making of the Committee

The Administration is concerned that the legislation imposes procedural requirements, such as roll call voting and motions, which are ill-suited for executive bodies such as CFIUS and are inconsistent with the vesting of the executive power in the President. Given the bill's reporting requirements, such procedures will deter the full and open interagency discussion that is required to consider CFIUS cases properly.

The Administration fully shares Congress' goal of ensuring senior-level accountability for CFIUS decisions. The Administration supports requiring the Secretary, Deputy Secretary, or an Under Secretary of the Treasury to sign CFIUS decisions at the conclusion of a second-stage (45-day) investigation, as H.R. 556 provides. With respect to cases for which CFIUS concludes its action at the end of the first-stage (30-day) investigation, the Administration supports the House Financial Services Committee's decision to authorize delegation of this authority. However, in view of the volume and variety of cases and to ensure that our most senior officials are able to focus on those cases that do raise national security concerns, this authority should be further delegable to other officials appointed by the President and confirmed by the U.S. Senate.

The Administration believes that the current 30-day and 45-day time frames for first-stage and second-stage investigations provide CFIUS with sufficient time to examine transactions. The possibility of extensions may discourage foreign investment by generating uncertainty and delay for the parties to proposed transactions. The Administration therefore opposes allowing CFIUS to extend the second stage (45-day) investigation period. The Administration notes that the current CFIUS practice of encouraging parties to transactions to consult with CFIUS prior to filing provides CFIUS with additional time and flexibility to examine complex transactions.

The Administration supports the role of the intelligence community as an independent advisor to CFIUS and appreciates the bill's inclusion of a provision that ensures that the Director of National Intelligence (DNI) is provided adequate time to complete the DNI's analysis of any threat to the national security of a covered transaction. However, language in H.R. 556 also appears to provide the DNI with the ability to force a second-stage (45-day) investigation if the DNI has identified particularly complex intelligence concerns and CFIUS was not able to satisfactorily mitigate the threat. Such a policy role would be inconsistent with the independent advisory role of the DNI envisioned in the legislation and supported by the Administration.

Notification and Reports to Congress

The Administration supports enhanced communication with Congress on CFIUS matters to better facilitate Congress' performance of its functions. CFIUS should be required to notify Congress of transactions only after all deliberative action is concluded, as H.R. 556 provides. As discussed above, roll call voting, particularly if reported outside the Executive Branch, would deter the full and open interagency discussion that is required to consider CFIUS cases, and reporting on internal Executive Branch deliberations, including the positions of individual CFIUS members, should not be required.

Authorities of CFIUS

The Administration believes current law and regulations give the President and CFIUS adequate authority to gather all information needed to conduct CFIUS investigations. The Administration is concerned that provisions of the bill that provide CFIUS with additional statutory authority to collect evidence and require the attendance and testimony of witnesses and the production of documents would make the CFIUS process more adversarial and less effective.

The Administration believes its ability to protect national security would be enhanced by a statutory grant of authority to impose civil penalties for a breach of a mitigation agreement. This authority to seek civil penalties, which could be calibrated to the seriousness of the noncompliance, would be a useful and effective tool for enforcing those agreements.

Presidential Review and Decision

The Administration supports requiring the President to make the final decision on a case only when CFIUS recommends that a transaction be blocked or when CFIUS fails to reach a consensus after a second-stage investigation. Requiring Presidential action in a broader set of cases would undermine the President's ability to determine how best to exercise Executive Branch decision-making authority.

The Administration looks forward to working with Congress on these important issues.

OVERSEAS ATTACHÉ PROGRAM

Question. Overseas attachés work in tandem with the Office of International Affairs and the Office of Terrorism and Financial Intelligence, as well as the relevant U.S. Embassies, to build relationships with foreign officials and to work with local U.S. industry, market and agency representatives.

What are the main purposes of the overseas attaché program?

To what extent are they involved with your anti-terrorism program?

How many attachés do you currently have around the world?

You are in the process of expanding the program and we gave you additional funds in the recent 2007 CR to do it. How far do you intend to expand the program in 2007 and 2008?

What qualifications are you seeking in candidates to fill these jobs?

Answer. The attaché program is essential for several priorities, including those related to:

—Building Treasury's expertise on economic and financial sector issues and fostering stronger substantive dialogues that can advance U.S. Government objectives.

—Identifying policy or regulatory barriers to U.S. firms and exports, particularly in the area of financial services.

—Strengthening cooperation with other countries to implement U.N. resolutions and U.S. enforcement actions to prevent and punish money laundering, terrorism and proliferation financing, and other financial crimes.

—Coordinating closely with other U.S. agencies and multilateral donors (such as the IMF and World Bank) to advance economic growth and development. This is particularly important in countries with a large U.S. Government presence, such as Iraq and Afghanistan.

As of April 2007, Treasury has eight attachés in China, Japan, Southeast Asia (Singapore), Afghanistan, Iraq, Belgium, Brazil, and Egypt. We expect to place an attaché in India in the coming months. Treasury is planning to open another nine attaché posts during fiscal year 2007-fiscal year 2008, tentatively slated to include Abu Dhabi, Istanbul, Riyadh, Islamabad, Johannesburg, Mexico City, London, Jakarta, and Tel Aviv.

To fill these positions, Treasury has been seeking professionals who can represent Treasury effectively within the U.S. Embassy and with senior officials of their counterpart countries, enhancing the effectiveness of Treasury's policy engagement. These tasks require a variety of substantive and interpersonal skills, including those related to macroeconomic analysis, financial sector development, and money laundering and the financing of terrorism. The precise nature of the substantive expertise will vary by country. For example, in Japan knowledge of macroeconomic and financial sector issues in a mature economy is critical. In contrast, experience with emerging markets and development issues is more important in attaché posts such as Egypt and in Southeast Asia. In other posts, the principal focus will be on terrorist financing issues, putting a premium on familiarity with financial sector issues and U.S. Treasury authority to fight financial crimes.

ESTABLISHMENT OF DYNAMIC TAX OFFICE AT TREASURY

Question. In last year's budget request, Treasury requested $513,000 to set up a Dynamic Analysis Division within the Office of Tax Policy.

Are you making the same request in this year's budget?

Can you tell us how such an office would work and what its purpose would be?

Answer. The initial request to establish a Dynamic Analysis Division within the Office of Tax Policy was included in the President's 2007 budget request; however, due to the CR, the request was not enacted. A similar request is therefore included in this year's budget. If funded, Treasury would hire a director and several staff for the division. The purpose of the division, as the name suggests, would be to conduct dynamic analysis of tax proposals. Dynamic analysis incorporates a broad range of behavioral responses to tax changes and provides an estimate of how those tax changes affect aggregate labor supply, savings and national income in both the near term and the long run. This analysis would improve the policy making process by providing information to policy makers about the economic effects of tax proposals. Treasury already provides estimates of revenue and distributional effects of tax proposals, but does not normally provide estimates of the effects of tax proposals on national savings or output. Treasury's analysis will help inform and complement the type of dynamic analysis currently being done by the Joint Committee on Taxation and the Congressional Budget Office.

In analyzing the revenue effect of potential tax policy changes, Treasury routinely considers how taxpayers might respond to the changes, but does not consider how the overall economy might be affected in its official scoring of tax proposals. Dynamic scoring of tax proposals would take dynamic analysis a step further by estimating how the change in economic activity translates into changes in tax receipts. Under the current proposal, Treasury would commit to conducting dynamic analysis of major tax policy changes, but not to dynamic scoring. Treasury plans to continue to rely on their traditional approach for "official" estimates of the revenue effect of the tax proposals, and to present dynamic analyses as supplemental information.

PERSONALLY IDENTIFIABLE INFORMATION

Question. In the past year, there have been numerous incidents regarding the loss or theft of federal computers and disk drives at different agencies where the names and social security numbers of citizens may have been compromised. In one incident, VA reported the loss of a notebook computer that contained Personally Identifiable Information for 26 million veterans. Other incidents were reported by a number of federal departments.

What is the Department doing to protect Personally Identifiable Information?

Is the Department in compliance with the OMB recommendations on this? If not, what are its plans to become compliant and by when?

Answer. The protection of sensitive personal and taxpayer information is of critical importance to the Department as is our ability to fulfill the Department's responsibilities to our citizens.

The Department has an important obligation to exercise extraordinary diligence in handling Personally Identifiable Information entrusted to our care and is taking aggressive actions to avoid it being compromised. Towards protecting Personally Identifiable Information, approximately 90 percent of Treasury laptops, including 99 percent of IRS laptops, have been encrypted (in accordance with FIPS 140–2 encryption standards) including installation of an automatic full disk encryption solution. Additionally, some of the remaining 10 percent of Treasury laptops have limited encryption already installed (e.g., specific folder encryption.) We are planning for a 99 percent+ completion rate by the end of June. We are also working to provide enhanced protection to other portable IT devices, specifically including Blackberries, which contain Personally Identifiable Information.

Additionally, in response to recommendations of the President's Identity Theft Task Force and the Office of Management and Budget, Treasury is in the process of establishing a Personally Identifiable Information Risk Management Group (PIIRMG). The Department is currently identifying points of contact as well as membership consistent with those identified in the Task Force recommendations and anticipates the initial PIIRMG kick-off meeting in the coming weeks. The establishment of the PIIRMG is an important component of our risk management efforts in the area of Personally Identifiable Information, particularly as Treasury Bureaus establish the capability to assess any Personally Identifiable Information-related incident that may occur and make recommendations for corrective and risk-reduction action to the PIIRMG.

Following OMB's recent memorandum titled "Safeguarding Against and Responding to the Breach of Personally Identifiable Information," over the next 120 days

Treasury will review and reduce its current holdings of PII reduce them to the minimum necessary for the proper performance of a documented agency function. Treasury will also, within 120 days, review its use of social security numbers (SSN) in agency systems and programs to identify instances in which collection or use is superfluous, as well as establish a plan in which it will eliminate the unnecessary collection and use of SSN within eighteen months.

INFORMATION SECURITY

Question. The Inspector General has noted that the Department needs to improve its information security program and practices to achieve compliance with the Federal Information Security Management Act and OMB requirements. The Act, as you know, was meant to bolster computer and network security within the Federal Government and affiliated parties (such as government contractors) by mandating yearly audits. The IG's 2006 evaluation disclosed deficiencies that constitute substantial noncompliance with the Act.

What steps are you taking to come into compliance with that Act?

Answer. Providing adequate security for the Federal government's investment in information technology (IT) is a significant undertaking and the Department is working towards improving its posture in this area. Our on-going efforts include taking steps to refine systems inventory for completeness and consistency, issuing Treasury policy in support of FISMA requirements, and strengthening the process for security remediation efforts.

In the area of inventory management, the Department has defined the inventory of major information systems (including national security systems) operated by or under the control of the Department, as originally required by the Paperwork Reduction Act of 1995. As an indication of our progress, for the first time, in the OIG's 2006 FISMA evaluation, it was noted that "[a]ll agency systems were accounted for on the inventory." Furthermore, Treasury issued Department-wide guidance on major and minor systems to ensure a consistent Treasury-wide approach in compiling system inventories.

Treasury policy, in support of our FISMA compliance efforts, seeks to secure the information and information systems that support the operations and assets of Treasury, including those provided or managed by another agency, contractor, or other source on behalf of the Department. Clarifying guidance has been issued for contractor systems to ensure those systems are consistently and completely identified in the Department's systems inventory and that they comply with security requirements. Policy has also been issued to address acceptable system configuration requirements and to define our vulnerability management policy. Developing policy and ensuring compliance across the Department is an ongoing effort, but an area in which progress is being made.

In order to strengthen Treasury's remediation efforts, and come into compliance with FISMA, the Department is developing a process for planning, implementing, evaluating, and documenting remedial action (Plan of Actions & Milestones, or POA&M) to address any deficiencies in the information security policies, procedures, and practices. In 2006, our POA&M process was judged to be effective, a significant improvement from 2005. Lastly, the Department continues to work to make progress in improving the quality of the certification and accreditation of its systems, testing of security controls and contingency plans, incident reporting, and employee training on systems security. The President's 2008 budget request includes significant investments in information security, including $21 million for the IRS' Computer Security Incident Response Center and network infrastructure security.

Question. Secretary Paulson, I understand that the United States is currently negotiating an OECD convention called the Large Aircraft Sector Understanding, which deals with the financing terms of aircraft, and that the negotiations are near conclusion. However, I have heard from U.S. industry that they do not believe their concerns have been addressed in the context of the negotiations. I am advised that the U.S. industry has prepared a comprehensive text that outlines its major concerns.

Given that the health of the U.S. aerospace industry is critical to the economy, the national security and the technological base of the United States, I respectfully request that you meet with the industry group that prepared the report to discuss the negotiations, and that you and your team at Treasury carefully review the industry position before agreeing to critical provisions put forward by the EU, which could hinder the ability of American companies to compete.

Answer. The U.S. Government negotiating team, led by Treasury, has been in continuous contact with industry throughout the negotiating process. That process has been underway for over two years. We will continue to consult intensively before

reaching a final agreement. Over the past two months, the Deputy Secretary, Under Secretary, and Assistant Secretary have all met with industry representatives to gather their views.

These consultations have occurred primarily through the Department of Commerce-led Aerospace Industry Trade Advisory Committee (ITAC) and the Aircraft Working Group (AWG—an international industry group for which Boeing serves as Vice Chairman). The AWG has met with OECD negotiators on a number of occasions, and has also provided formal written recommendations on the important competitive elements of an agreement. Treasury has followed appropriate procedures for reviewing the ITAC's recommendations, and the positions taken by the U.S. negotiators to date are in full accord with those recommendations.

Treasury officials and substantive experts met several times with key industry representatives, including meetings as recently as the week of April 16th. In these meetings, the detailed industry-recommended text was thoroughly examined point-by-point, and U.S. negotiators worked with this text in discussions with other negotiators at the OECD the week of April 23.

I can assure you that the provisions of this new agreement will ensure that U.S. industry will remain fully competitive. We will support an agreement that provides a level playing field for our exporters. The agreement will also sharply limit the ability of foreign governments to provide subsidized financing for their aerospace industries' exports. By limiting these subsidies, we will also limit subsidies that are currently provided to foreign airlines and that disadvantage our domestic airline industry, which does not have access to such subsidies.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. You've asked for some increases in your budget in the areas of Terrorism and Financial Intelligence and in the International economic policy area. Can you tell me a little bit about the Treasury's work in these areas and why these increases are important?

Answer. The Terrorism and Financial Intelligence and International economic policy areas budget increases reflect the Department of the Treasury's expanding mission in these areas.

Terrorism and Financial Intelligence

The Treasury, and the Office of Terrorism and Financial Intelligence, in particular, has requested additional resources to increase the implementation of strategies and employment of targeted financial measures to disrupt and dismantle the financial networks that support terrorism, WMD proliferation, and organized crime. Targeted financial measures developed since 9/11 to combat terrorist support networks can and should be used to disrupt and dismantle the networks that support other threats. These types of financial measures have proven effective, in part because they unleash market forces by highlighting the risks and encouraging prudent and responsible financial institutions to make the right decisions about the business in which they are engaged. Treasury uses designations strategically to disrupt specific sources, means, and mechanisms of terrorist financing, including radical ideologues, charities and other sources and conduits of terrorist financing and support.

The fiscal year 2008 President's budget requests additional analysts and production officers for the Office of Intelligence and Analysis to support Treasury's ability to address emerging national security threats. This request will allow Treasury to establish a permanent intelligence production structure, an essential component to the timely and accurate production of intelligence information. In addition to this initiative, OIA is seeking additional funds and personnel to expand the Department's ability to coordinate on terrorist-financing and WMD proliferation matters, and to improve OIA's working relationships with foreign intelligence services.

The Office of Terrorist Financing and Financial Crimes, the policy and outreach apparatus for TFI, develops and implements strategies, policies and initiatives to identify and address vulnerabilities in the United States and the international financial system and to disrupt and dismantle terrorist and WMD proliferation financial networks. Treasury's request would give the Office of Terrorist Financing and Financial Crimes (TFFC) additional resources to devote specific policy advisors to critical regions in the Western Hemisphere, Africa, and the Middle East-South Asia nexus. Countries in these regions continue to provide a financial base for terrorists. Additional advisors would allow TFFC to meet multiple strategic objectives, including enhancing the Treasury Department's ability to disrupt terrorist financial and support networks and building the capacity of foreign governments to combat ter-

rorist financing. Without adequate full-time staff dedicated to these region-specific issues, U.S. strategic priorities and specific Treasury responsibilities cannot be addressed in a comprehensive or strategic manner.

TFFC has also requested additional resources to increase our development of strategies toward rogue regimes and their corresponding networks. North Korea, Syria, and Iran pose a constant threat to U.S. national security, and Treasury is tasked with applying all appropriate financial measures towards pressuring these rogue regimes, isolating them from the international financial system, and disrupting their financial networks.

Treasury's request would fund additional policy advisors to cover North Korea, Syria, and Iran and would allow the Treasury Department to leverage tactical successes to develop ongoing strategic approaches to bring additional financial pressures. These positions would become the focal point for interagency efforts to bring financial pressures to bear against these rogue regimes, enhancing Treasury's ability to meet its strategic objectives and U.S. strategic priorities. In addition to achieving sustained, focused pressure on Iranian, Syrian, and North Korean WMD proliferation finance, criminal and terrorist financing activities, Treasury would establish future strategies on emerging regimes of concern (e.g., Venezuela). These positions would also provide TFFC the ability to provide support and guidance to senior NSC officials dealing with the relevant issues. This initiative is consistent and in support of Executive Orders 13338 and 13382 and Section 311 of the USA PATRIOT Act.

The Office of Foreign Assets Control (OFAC), an office within TFI, is responsible for administering and enforcing economic sanctions based on U.S. foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers and those engaged in activities related to the proliferation of weapons of mass destruction. Treasury's request would also give OFAC additional resources to implement U.S. economic sanctions policy. OFAC is committed to combating terrorist networks and state sponsors of terrorism. New Executive Orders with respect to Sudan and Syria were issued in 2006, and the Administration is also extensively engaged with respect to Iran. Each new Executive Order and/or OFAC designation of terrorists and their financial networks brings with it increasing demands on OFAC's enforcement, licensing, compliance and administrative support components. Additional resources in these areas are requested to match the increased tempo of new Executive Orders and Treasury designations.

In addition, the WMD sanctions program is a Presidential national security priority and these resources will be used to strengthen OFAC's ability to track, identify and designate financiers and other supporters of WMD proliferation. Publicizing the designations, and assigning resources to enable OFAC to engage in outreach to the private sector and with government agencies, will greatly assist the Treasury Department in effectively isolating financiers and facilitators of WMD proliferation from the United States and international commercial communities. This request will also provide OFAC with additional resources to generally expand its enforcement capacity in support of investigation and blocking activities, which are critical to the enforcement of sanctions.

International Affairs

With the increasing importance of global economics and dynamics, the Department of the Treasury is increasing its international focus. First, the Executive Direction area is seeking additional positions and funding to effectively manage the U.S.-China Strategic Economic Dialogue (SED) and maximize the likelihood of progress on issues of concern to the United States such as the Chinese currency, energy and the environment, and intellectual property rights. The SED reflects the growing relationship between the economies of the United States and China, and is structured to provide a focused framework for addressing such issues of concern.

Additionally, the Department of the Treasury, in its role as chair of the interagency Committee on Foreign Investment in the United States (CFIUS), has seen its responsibilities increase exponentially. CFIUS is responsible for monitoring and evaluating the impact of foreign investment in the United States, including for national security implications. In addition, CFIUS is the President's designee under Exon-Florio. In that capacity, CFIUS conducts in-depth national security investigations of transactions notified to CFIUS under Exon-Florio. The 2008 request includes additional resources to match the growth in transactions submitted for CFIUS review.

The increase in CFIUS activity is described below:

—CFIUS investigated 113 transactions in 2006—a 74 percent increase over the number of transactions for 2005 (65) and 85 percent more than the annual average (61). This increase can be attributed to a rise in cross-border merger and

acquisition activity, an increase in international investor awareness of CFIUS and its role, and higher scrutiny of the security concerns posed by acquisitions of U.S. businesses by foreign-owned companies.

—The percentage of transactions that proceeded to a 45-day second-stage investigation also increased significantly last year, to seven from two in 2005. Second-stage investigations require significant involvement of very high-level officials and commitment of staff resources.

—CFIUS member agencies negotiate security agreements with the parties to a transaction in order to mitigate national security concerns raised by the transaction. In 2006 alone, 16 agreements were negotiated, which was 35 percent of all CFIUS-related agreements negotiated since 1997. Last year CFIUS also prepared two reports on notified transactions recommending to the President how the case should be resolved. This is the largest number since 1990, when four such reports were sent. Each mitigation agreement and report to the President requires significant resources.

—CFIUS anticipates an even greater number of transactions to be filed in 2007 and plans to continue to conduct thorough reviews in the context of an open investment policy. We have received approximately 65 filings and negotiated five mitigation agreements to date in 2007.

—CFIUS has also increased its reporting to Congress, providing the relevant committees with information pertaining to every case once deliberative action has concluded. We also provide periodic briefings to Congressional oversight committees on all cases for which deliberative action has concluded.

As you well know, the Department of the Treasury received funds in fiscal year 2007 to expand its overseas presence through the establishment of Treasury attachés in countries such as Iraq, China and Afghanistan. Funding is requested for the full fiscal year 2008 cost and FTE realization from this fiscal year 2007 initiative.

The attaché program is essential for several priorities, including those related to:

—Building Treasury's expertise on economic and financial sector issues and fostering stronger substantive dialogues that can advance U.S. Government objectives.

—Identifying policy or regulatory barriers to U.S. firms and exports, particularly in the area of financial services.

—Strengthening cooperation with other countries to implement U.N. resolutions and United States enforcement actions to prevent and punish money laundering, the financing of terrorism, and other financial crimes.

—Coordinating closely with other United States agencies and multilateral institutions (such as the IMF and World Bank) to advance economic growth and development. This is particularly important with places with a large U.S. Government presence, such as Iraq and Afghanistan.

Question. Please explain how you plan to block U.S. commercial bank transactions connected to the government of Sudan?

Answer. The United States has maintained comprehensive economic sanctions with respect to Sudan since 1997. Under Executive Order 13067 of November 3, 1997, implemented through the Sudanese Sanctions Regulations, 31 C.F.R. Part 538, the United States government already requires U.S. persons to block all property and interests in property of the Government of Sudan. All major U.S. banks, including their foreign branches, and the U.S. offices of foreign banks, have programs in place to detect and block such transactions as they are processed. Treasury is working actively to enhance implementation and compliance to ensure that it is as responsive as possible.

On October 13, 2006, the President issued Executive Order 13412 to implement the Darfur Peace and Accountability Act of 2006. E.O. 13412 continues the countrywide blocking of the Government of Sudan's property and interests in property and prohibits all transactions by U.S. persons relating to Sudan's petroleum and petrochemical industries. E.O. 13412 also removes the regional government of Southern Sudan from the definition of Government of Sudan.

In addition to these targeted sanctions, OFAC administers a targeted sanctions program against persons in connection with the conflict in Sudan's Darfur region. This program stems from Executive Order 13400 of April 26, 2006, in which the President ordered the blocking of four individuals listed in the Annex to the order, and of additional persons who meet the specified criteria set forth in the order.

Question. Last year, the Department identified the following as the three most immediate challenges for TFI: (1) the need for additional resources to more aggressively pursue core objectives, (2) leveraging its authorities most effectively to deal with Iran and Syria, and (3) building the information technology systems necessary

to effectively and efficiently carry out TFI's mission. Could you give us an update of where Treasury stands in meeting these challenges?

Answer. Treasury has taken significant steps forward in addressing key national security threats, particularly terrorism and WMD proliferation, but there is still important work to be done on these and other emerging threats. The requested resources will improve Treasury's ability to expand its coverage of current national security threats and allow the Department to adapt to new emerging threats.

The fiscal year 2008 President's budget requests additional analysts and production officers to support Treasury's ability to address emerging national security threats. In fiscal year 2005, when OIA was created, the Office focused on developing a process for exploiting current intelligence. In fiscal year 2006, OIA improved its strategic analytic capability and developed a research program, which was coordinated with IC partners. In the current fiscal year, OIA is concentrating on building breadth and depth to its analytic cadre, so that OIA can better address some of the national security threats that have developed in the past year. Still, to fulfill the intent of Congress and Treasury leadership when they created the Office, OIA must increase the systemic analysis of issues underlying key national security threats. This request will also allow Treasury to establish a permanent intelligence production structure, an essential component to the timely and accurate production of intelligence information. In addition to this initiative, OIA is seeking additional funds and personnel to expand the Department's ability to coordinate on terrorist-financing and WMD proliferation matters, and to improve OIA's working relationships with foreign intelligence services.

The fiscal year 2008 President's budget requests additional resources to support the Office of Foreign Assets Control (OFAC), an office within TFI,which is responsible for administering and enforcing economic sanctions based on U.S. foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers and those engaged in activities related to the proliferation of weapons of mass destruction. The fiscal year 2008 request would give OFAC additional resources to implement U.S. economic sanctions policy combating terrorist networks and state sponsors of terrorism. New Executive Orders with respect to Sudan and Syria were issued in 2006, and the Administration is also extensively engaged with respect to Iran. Each new Executive Order and/or OFAC designation of terrorists and their financial networks brings with it increasing demands on OFAC's enforcement, licensing, compliance and administrative support components. Additional resources in these areas are requested to match the increased tempo of new Executive Orders and Treasury designations. In addition, resources are requested to strengthen OFAC's ability to track, identify and designate financiers and other supporters of WMD proliferation. The WMD sanctions program is a Presidential national security priority. Publicizing the designations, and assigning resources to work with the U.S. public will greatly assist the Treasury Department in effectively isolating financiers and other supporters of WMD proliferation.

The Treasury Department has drawn upon its full range of authorities and influence to combat threats including WMD proliferation and terrorism. The strategies we have employed to combat the threats posed by Iran and Syria are good examples of the ways in which financial authorities are effective in dealing with state sponsors of terrorism.

Iran

Formal Measures

Treasury has acted both formally and informally to combat the threat emanating from Iran, which includes a threat to the international financial system. Iran's dangerous activities, including the sponsorship of terrorism and the pursuit of a nuclear weapons program, rely on access to financial networks and financial systems. Our efforts to attack the financial roots of these threats work to simultaneously protect our own financial institutions as well as the international financial system.

First, it must be noted that the United States has a longstanding country sanctions program against Iran. These commercial and financial sanctions, which are administered by the Treasury's Office of Foreign Assets Control (OFAC), prohibit U.S. persons from engaging in a wide variety of trade and financial transactions with Iran or the Government of Iran. They prohibit most trade in goods and services between the United States and Iran, and any post-May 7, 1995, investments by U.S. persons in Iran. U.S. persons are also prohibited from facilitating transactions via third-country persons that they could not engage in themselves.

Beyond these general country sanctions, we are relying more and more on "targeted" measures directed at specific individuals, key members of the government, front companies, and financial institutions. These measures are aimed at specific actors engaged in specific conduct. Some require financial institutions to freeze funds

and close the accounts of designated actors, denying them access to the traditional financial system. At times, the action includes bans on travel or arms transfers, which further confine and isolate those engaged in illicit activities. To maximize the effect, we try to apply these measures in concert with others. Whenever possible, we act with a partner or a group of allied countries.

The United States is using various types of targeted measures to combat Iran's pursuit of nuclear weapons and development of ballistic missiles, as well as its support for terrorism. First, while under our general Iran country sanctions program Iranian financial institutions are prohibited from directly accessing the U.S. financial system, they are permitted to do so indirectly through a third-country bank for authorized payments, including payments to another third-country bank. In September 2006, we cut off one of the largest Iranian state-owned banks, Bank Saderat, from any access, including this indirect, or "u-turn," access to the U.S. financial system. This bank, which has 25 foreign branch offices, is used by the Government of Iran to transfer money to terrorist organizations. Iran has used Saderat to transfer money to Hizballah. Iran and Hizballah also use it to transfer money to E.U.-designated terrorist groups, such as Hamas, the PFLP–GC, and the Palestinian Islamic Jihad. Since 2001, for example, a Hizballah-controlled organization received $50 million directly from Iran through Saderat.

We have also acted against 19 entities and individuals supporting Iran's WMD and missile programs, including another Iranian bank, Bank Sepah, using Executive Order 13382. That Executive Order, signed by President Bush in June of 2005, authorizes the Treasury and State Departments to target key nodes of WMD and missile proliferation networks, including their suppliers and financiers, in the same way we target terrorists and their supporters. A designation under E.O. 13382 effectively cuts the target entity or individual off from access to the U.S. financial and commercial systems and puts the international community on notice about the threat they pose to global security as a result of their activities. Specifically, such a designation freezes any assets that the target may have under U.S. jurisdiction and prohibits U.S. persons from doing business with it.

Senior Treasury officials have traveled all over the world, sharing a U.S. list of Iran-related designations with foreign government counterparts and private sector representatives, and stressing the importance of ensuring that these proliferators are not able to access the international financial system. Our list of targeted proliferators is incorporated into the compliance systems at major financial institutions worldwide, who have little appetite for the business of proliferation firms and who also need to be mindful of U.S. measures given their ties to the U.S. financial system.

The Treasury's designation of Iran's state-owned Bank Sepah under E.O. 13382 in January of this year is particularly significant because it makes it more difficult for the regime to hide behind its banks to support its proliferation activities. Like certain other Iranian banks and entities, Bank Sepah has engaged in a range of deceptive practices in an effort to avoid detection, including requesting that other financial institutions take its name off of transactions when processing them in the international financial system.

Informal Measures

Aside from these "formal" actions, the Treasury has engaged in unprecedented, high-level outreach to the international private sector, meeting with more than 40 banks worldwide to discuss the threat Iran poses to the international financial system and to their institutions. Secretary Paulson kicked off this effort last fall in Singapore, in discussions during the annual IMF/World Bank meetings, where he met with the executives from major banks throughout Europe, the Middle East, and Asia. Secretary Paulson, Deputy Secretary Kimmitt, Under Secretary for Terrorism and Financial Intelligence Stuart Levey, and Assistant Secretary for Terrorist Financing and Financial Crimes Patrick O'Brien have continued to engage with these institutions abroad, as well as in Washington and New York.

Through this outreach, we have shared information about Iran's deceptive financial behavior and raised awareness about the high financial and reputational risk associated with doing business with Iran. Our use of targeted measures has aided this effort by allowing us to highlight specific threats. We share common interests and objectives with the financial community when it comes to dealing with threats. Financial institutions want to identify and avoid dangerous or risky customers who could harm their reputations and business. And we want to isolate those actors and prevent them from abusing the financial system.

By partnering with the private sector, including by sharing information and concerns with financial institutions, we are increasingly seeing less of a tendency to work around sanctions.

As evidence of Iran's deceptive practices has mounted, financial institutions and other companies worldwide have begun to reevaluate their business relationships with Tehran. Many leading financial institutions have either scaled back dramatically or even terminated their Iran-related business entirely. They have done so of their own accord, many concluding that they did not wish to be the banker for a regime that deliberately conceals the nature of its dangerous and illicit business. Many global financial institutions have indicated that they have limited their exposure to Iranian business. A number of them have cut off Iranian business in dollars, but have not yet done so in other currencies. It is unclear whether this is just a first step toward phasing out the business entirely. Regardless of the currency, the core risk with Iranian business—that you simply cannot be sure that the party with whom you are dealing is not connected to some form of illicit activity—remains the same. Scaling back dollar-business reduces, but does not eliminate, the risk.

As further evidence of the change in tide, a number of foreign banks are refusing to issue new letters of credit to Iranian businesses. And in early 2006, the OECD raised the risk rating of Iran, reflecting this shift in perceptions and sending a message to those institutions that have not yet reconsidered their stance.

Additionally, many other companies have scaled back on their investments or projects in Iran, concluding that the risks of expanding operations in the country are too great. Multinational corporations have held back from investing in Iran, including limiting investment in Iran's oil field development. These companies have done their risk analyses, and they have realized that the Iranian regime's behavior makes it impossible to know what lies ahead in terms of Iran's future and stability.

Syria

As in Iran, we have taken a combination of steps to address Syria's problematic behavior and the threats posed by Syria. Under Executive Order 13338, Treasury is applying targeted financial sanctions that provide for the blocking of the assets of individuals and entities that, among other things, contribute to Syria's support of international terrorism, military or security presence in Lebanon, pursuit of weapons of mass destruction and missile programs, and undermining of U.S. and international efforts in Iraq. E.O. 13399 provides for the blocking of individuals and entities who were involved in the assassination of the former Lebanese Prime Minister Rafik Hariri or certain other bombings or assassination attempts in Lebanon since October 1, 2004

In addition, four Syrian entities are subject to an asset freeze under the WMD proliferation sanctions program that was established in June 2005. The Scientific Studies and Research Centre (SSRC) was named by the President in the annex of Executive Order 13382. SSRC is the Syrian government agency responsible for developing and producing non-conventional weapons and the missiles to deliver them. While it has a civilian research function, SSRC's activities focus substantively on the acquisition of biological and chemical weapons. The three additional entities meet the criteria for designation under E.O. 13382 because they are subordinates of SSRC.

Second, we took action pursuant to the USA PATRIOT Act's Section 311 to protect the U.S. financial system against the Commercial Bank of Syria (CBS). Criminals and terrorists have utilized CBS to facilitate or promote money laundering and terrorist financing, including the laundering of proceeds from the illicit sale of Iraqi oil and the channeling of funds to terrorists and terrorist financiers. In March 2006, Treasury issued a final rule, pursuant to Section 311, designating CBS as a primary money laundering concern. This additional step required U.S. financial institutions to close correspondent bank accounts with CBS, which essentially halted U.S. business with CBS.

As a result of these U.S. enforcement measures against Syria-based entities engaging in illicit financial activity, international financial institutions have reassessed their business relationships with Syria and a number of Syrian entities.

Responding to the need for information technology systems, funding for Enterprise Content Management (ECM) will be used to implement a pilot enterprise-wide ECM project for the Department, initially meeting the critical and urgent business needs of the Office of Foreign Assets Contract (OFAC) and the Financial Crimes Enforcement Network (FinCEN). The project, which is under the oversight of the Department's Chief Information Officer, will be designed to meet Department-wide ECM requirements, thereby minimizing duplication of effort and infrastructure investments by capitalizing on Department and government-wide efforts.

Treasury is also currently in the midst of a multi-year project to upgrade the Treasury Foreign Intelligence Network (TFIN), which is the Department's system authorized for both Top Secret and Sensitive Compartmented Information. Treasury has made significant progress in stabilizing the system and as a result, Treasury

analysts are already using IT tools like Intellipedia and classified Instant Messaging to better cooperate with counterparts across the IC.

Treasury's CIO is currently modernizing TFIN to enhance the analytical work flow and add additional analytic tools. In fiscal year 2008, the Department has requested $3 million for operations and maintenance, to ensure the system is maintained and upgraded as necessary.

Question. With the establishment of TFI, how are intelligence activities coordinated with other federal agencies and the Office of the Director of National Intelligence?

Answer. The Department of the Treasury's analytic efforts are guided by its research and production plan, which was created to ensure that its analytic priorities were consistent with those of the DNI, the National Security Council (NSC), and the Treasury Department. This plan is also extensively coordinated throughout the IC. Because of this coordination and through other bilateral exchanges, opportunities for joint projects with IC partners have grown since OIA was created in 2005.

—In early 2006, Treasury and the Federal Bureau of Investigation (FBI) worked in concert to preserve the assets of Toledo-based NGO KindHearts, as the NGO and its officers faced allegations of terrorism finance.

—Treasury co-founded and co-leads, with the Department of Defense, the Iraq Threat Finance Cell (ITFC) in Baghdad, Iraq. The ITFC's mission is to enhance the collection, analysis, and dissemination of intelligence to combat the financing of terrorist and insurgent groups in Iraq. ITFC participating agencies include other members of the IC, as well as FBI, Secret Service, and IRS Criminal Investigations.

—Treasury collaborated with other IC agencies to identify and map Iranian Weapons of Mass Destruction (WMD) proliferation networks, while supporting the targeting of WMD proliferation entities for Treasury action.

Question. What progress has been made on cross-border currency transactions, wire transfers, and effective oversight with other countries?

Answer. Systems for the collection, storage, processing, analysis, and dissemination of cross-border electronic funds transfers are in place. Both the Australian and Canadian governments, through their financial intelligence units, have imposed cross-border electronic funds transfer reporting requirements on their financial services industries.

Canada

The Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) is Canada's financial intelligence unit.

FINTRAC first required the reporting of cross-border electronic funds transfers ("EFT" reporting) in June 2002. Initially, FINTRAC required only reports of international funds transfers made using certain SWIFT messages. Effective March 31, 2003, FINTRAC expanded the international EFT reporting requirement to cover all forms of international EFT regardless of system or message format. FINTRAC receives almost all of its international EFT reports electronically; FINTRAC's regulations permit for paper filing where the reporting institution can certify that they lack the capability to file electronically, but FINTRAC officials noted that this rarely happens.

To facilitate the electronic filing of these reports, FINTRAC established a "batch file transfer format" that informs financial institutions of the appropriate report content and form. In turn, reporting institutions must implement their own systems for converting the institutions' non-SWIFT data to the proper format prior to submission. For non-SWIFT EFTs, FINTRAC has also developed an online form that is generally used by smaller institutions. For both SWIFT and Non-SWIFT messages, FINTRAC has established minimum mandatory data fields (17 fields for outgoing SWIFT messages; 8 fields for incoming SWIFT messages; 11 fields for both outgoing and incoming Non-SWIFT messages) that must be included in the report (again, FINTRAC dictates the format of the batch submission, but distinguishes between mandatory fields and those fields).[1]

More than 300,000 entities and persons are potentially subject to the EFT reporting requirement in Canada, but many do not conduct business that reaches the thresholds in the law and thus, need not report. In addition, not all types of regulated institutions are currently required to report. However, the Department of Finance has issued a public consultation paper recommending that Parliament amend existing law to require all regulated entities to report cross-border EFTs. As noted above, FINTRAC permits reporting institutions to report by batch file and by single report through either a web-based interface or client software distributed by

[1] See http://www.fintrac.gc.ca/publications/guide/Guide8/81__e.asp.

FINTRAC. Currently 56 entities report via the batch process, with the others using the online reporting mechanism.

In total, FINTRAC receives approximately 590,000 international EFT transaction records per month.

—In 2003–04, FINTRAC received 2.7 million SWIFT EFT reports and 3.9 million Non-SWIFT EFT Reports.

—In 2004–05, FINTRAC received 3 million SWIFT EFT reports and 4.1 million Non-SWIFT EFT Reports.

—60 percent of all the FINTRAC reports are submitted by banks.

—FINTRAC's international EFT data store contains approximately 15.6 million records.

Australia

The Australian Transaction Reports and Analysis Centre (AUSTRAC) is the financial intelligence unit of the Australian government.

AUSTRAC first required the reporting of cross-border electronic funds transfers (International Funds Transfer Instructions or "IFTI" reporting) in 1992.[2] Generally, AUSTRAC requires the institutions "who are senders of IFTIs transmitted out of Australia; or who are receivers of IFTIs transmitted into Australia" submit reports of those transactions.

AUSTRAC accepts IFTI reports in one of two formats. First, AUSTRAC accepts reports containing properly formatted SWIFT instruction messages from those institutions that use the SWIFT system. Second, AUSTRAC established a batch file transfer format and requires the reporting institutions to implement their own systems for converting the institutions' non-SWIFT data to the proper format prior to submission. For both SWIFT and Non-SWIFT messages, AUSTRAC has established minimum mandatory data fields that must be included in the report.

AUSTRAC permits reporting institutions to report by batch file and by single report through a web-based interface operated by AUSTRAC. This interface enables institutions to upload prepared files automatically, provides an interface for the manual upload of prepared batch files, and provides a form for extremely low volume reporting institutions to submit their data. In addition, AUSTRAC developed and distributes to financial institutions a Microsoft Excel macro that will convert certain electronic records to the prescribed data format for upload to the AUSTRAC systems. AUSTRAC officials told us that the largest four institutions in Australia account for approximately 80 percent of the IFTI reporting, while a second tier of approximately 20 institutions account for the majority of the remaining reports.

In total, AUSTRAC receives approximately 9 to 10 million IFTI records per year.

—In 2003–04, AUSTRAC received approximately 4 million inbound and approximately 4.5 million outbound IFTI reports.

—In 2004–05, AUSTRAC received 4.2 million inbound IFTI reports and approximately 5.5 million outbound IFTI reports.

—The most recent figures reveal that in the course of a year, approximately 78 percent of the IFTI reports are in SWIFT format and 22 percent in non-SWIFT format.

—AUSTRAC's data store contains approximately 70 million records dating from 1995 to present; 55 million of those are IFTI reports.

Question. I understand that the United States is near concluding negotiations on the "Large Aircraft Sector Understanding," dealing with the financing terms of aircraft. I have been informed that the U.S. industry does not believe their concerns have been addressed in the context of the negotiations. They are troubled that agreeing to the provision put forward by the EU could hinder their ability to compete. Would you be willing to meet with the industry group to discuss their concerns?

Answer. The United States Government negotiating team, led by Treasury, has been in continuous contact with industry throughout the negotiating process. That process has been underway for over two years. We will continue to consult intensively before reaching a final agreement. Over the past two months, the Deputy Secretary, Under Secretary, and Assistant Secretary have all met with industry representatives to gather their views.

These consultations have occurred primarily through the Department of Commerce-led Aerospace Industry Trade Advisory Committee (ITAC) and the Aircraft

[2] The IFTI reporting provisions are set out in section 3 and sections 17B to 17F of the FTR Act. The prescribed details in relation to IFTIs are contained in Regulation 11AA of the Financial Transaction Reports Regulations 1990 (FTR Regulations); see also AUSTRAC Information Circular No. 2, available at http://www.austrac.gov.au/text/guidelines/circulars/pdfs/AIC%2002%20%20International%20Funds%20Transfer%20Instructions.pdf.

Working Group (AWG—an international industry group for which Boeing serves as Vice Chairman). The AWG has met with OECD negotiators on a number of occasions, and has also provided formal written recommendations on the important competitive elements of an agreement. Treasury has followed appropriate procedures for reviewing the ITAC's recommendations, and the positions taken by the U.S. negotiators to date are in full accord with those recommendations.

Treasury officials and substantive experts met several times with key industry representatives, including meetings as recently as the week of April 16th. In these meetings, the detailed industry-recommended text was thoroughly examined point-by-point, and U.S. negotiators worked with this text in discussions with other negotiators at the OECD the week of April 23.

I can assure you that the provisions of this new agreement will ensure that U.S. industry will remain fully competitive. We will not support any agreement that does not provide a completely level playing field for our exporters. The agreement will also sharply limit the ability of foreign governments to provide subsidized financing for their aerospace industries' exports. By limiting these subsidies, we will also limit subsidies that are currently provided to foreign airlines and that disadvantage our domestic airline industry, which does not have access to such subsidies.

Question. Treasury's Office of Intelligence Analysis was established in fiscal year 2005. Since that time, how has it contributed to overall intelligence collection?

Answer. The Treasury's Office of Intelligence Analysis (OIA) is primarily an analytic component. Through its membership in the Intelligence Community (IC), OIA has also been instrumental in driving collection on financial issues in the intelligence requirements process. At the national level, OIA created and filled a dedicated collection requirements officer position. This individual ensures that Treasury equities in financial, economic, enforcement, and other areas, are reflected in national intelligence priorities and collection requirements. At the working level, OIA analysts actively provide feedback and direction on disseminated intelligence reports to ensure that information relevant to Treasury's mission is collected. OIA analysts regularly engage with counterparts in collecting offices across the IC.

Treasury also is the program office for the Terrorist Financing Tracking Program (TFTP). Using its authorities, Treasury has access to certain very limited and targeted data streams that provide information about the financial activities of known terrorists.

Additionally, Treasury co-founded and co-leads, with the Department of Defense, the Iraq Threat Finance Cell (ITFC) in Baghdad, Iraq. The ITFC's mission is to enhance the collection, analysis, and dissemination of intelligence to combat the financing of terrorist and insurgent groups in Iraq. ITFC participating agencies include other members of the IC, as well as FBI, Secret Service, and IRS Criminal Investigations.

Question. What key ways is your Department proposing to employ to close the "tax gap?" You stated in a Finance Committee hearing that this is not a pot of gold. How big is the gap and what will it cost to close it?

Answer. The tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. Based in part on the results of a National Research Program (NRP) analysis of approximately 46,000 individual tax returns for Tax Year 2001, the IRS has estimated that the gross tax gap for Tax Year 2001 was $345 billion. After collections and late payments, the net tax gap for that year is estimated to be $290 billion. Although the IRS will never be able to audit its way out of the tax gap, considerable progress has been made in improving compliance as indicated by growth in enforcement revenues in recent years.

In September 2006, the Treasury Department released a document titled "A Comprehensive Strategy for Reducing the Tax Gap." The strategy builds upon the demonstrated experience and current efforts of the Treasury Department and IRS to improve compliance. See http://www.treasury.gov/press/releases/reports/otptaxgapstrategy%20final.pdf for a copy of this report. This strategy includes detailed legislative proposals, along with new initiatives to reduce opportunities for evasion, a commitment to research, continual improvements in technology, enhanced enforcement programs and taxpayer service programs, increased outreach and education and enhanced coordination and partnering with stakeholders.

The tax compliance strategy is reflected in the President's fiscal year 2008 budget request which includes sixteen legislative proposals to begin to address the tax gap with minimum impact on taxpayers. These proposals include requiring basis reporting on sales of securities; information reporting on merchant payment card reimbursements; increased information reporting for certain government payments for

property and services; and implementing standards to clarify when employee leasing companies can be held liable for their clients' Federal Employment taxes.

In addition, the fiscal year 2008 budget request provides:

—$205 million to expand enforcement activities, a majority of which will go to improve compliance among small business and self-employed (SB/SE) individual taxpayers. It will also fund implementation of the legislative proposals described above.

—$20 million to enhance taxpayer service, including expansion of volunteer tax assistance and research to determine the effect of service on taxpayer compliance.

—$41 million for research that will update estimates of reporting compliance. Unlike the past, the IRS will conduct an annual study of compliance among 1040 filers that will provide fresh compliance data each year, and by combining samples over several years will provide a regular update to the larger sample size needed to keep the IRS' targeting systems and compliance estimates up to date.

—$143 million for information technology that includes upgrades for critical infrastructure to prevent business operation disruptions and upgrades of IT security.

The IRS and Treasury Department will continue to work with OMB on future funding needs to support the implementation of its tax gap strategy.

Question. If we simplified our tax code with, for example, a flat income tax, what effect would there be on revenue receipts and revenue collection?

Answer. There are at least three potential effects on receipts from substituting a flat income tax for our current income tax. First, initial receipts under a flat tax could differ from those under the current income tax due to estimation error. There is some flat tax rate that initially would bring in the same amount of revenue as our current income tax. Depending on how much the flat tax base differs from the tax base of the current income tax, however, there may be more or less significant error in estimating the revenue-neutral flat tax rate. This error could be positive or negative. Second, a greatly simplified income tax could reduce the so-called "tax gap." Taxpayers who fail to understand the highly complex provisions of the current tax code are unlikely to be compliant with those provisions. While this noncompliance could result in overpayment or underpayment of taxes, there is strong belief that, on net, it results in underpayment. The complexity of our current tax code also is thought to provide opportunities for some taxpayers to intentionally underpay their taxes. Hence, a dramatically simplified income tax could result in a higher level of tax compliance, contributing to revenue collections. Third, under a truly flat income tax—that is, a tax with a single tax rate—revenues likely would grow more slowly than under our current income tax. As real incomes increase, our current progressive income tax taxes the higher real incomes at higher effective tax rates, resulting in tax receipt growth that exceeds income growth. Under a true flat tax, tax receipt growth would be more likely to equal, or nearly equal, income growth.

SUBCOMMITTEE RECESS

Senator DURBIN. The subcommittee hearing is recessed.

Thank you.

[Whereupon, at 5:01 p.m., Wednesday, March 28, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

WEDNESDAY, APRIL 11, 2007

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3:12 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Nelson, Brownback, and Allard.

OFFICE OF MANAGEMENT AND BUDGET

STATEMENT OF ROBERT J. PORTMAN, DIRECTOR

ACCOMPANIED BY ROBERT SHEA, ASSOCIATE DIRECTOR FOR MANAGEMENT

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Welcome to this meeting of the Senate Appropriations Subcommittee on Financial Services and General Government. We continue our budget hearings today with the Office of Management and Budget (OMB).

We welcome Director Rob Portman to the hearing along with his staff and associates.

I welcome my colleague, Senator Nelson of Nebraska, who has joined me and others who may arrive.

This budget request is for OMB, which serves as the President's eyes and ears on the budget. It's the executive branch agency responsible for putting together the President's budget, and all agency budget requests come through OMB.

It operates no programs of its own, but has great influence over programs as to how they're funded. OMB is responsible for preparing the President's budget, examining agency programs, analyzing legislation, preparing the Government's Financial Management Status Report and 5-year plan, reviewing and coordinating agency plans to implement or revise Federal regulations and information collection requirements, and providing overall direction of Government-wide procurement and outsourcing.

OFFICE OF MANAGEMENT AND BUDGET REQUEST

The administration's fiscal year 2008 request is for $78.8 million, an increase of $2.1 million, or 2.7 percent over fiscal year 2007 lev-

els. No additional personnel are requested, but additional funds are needed to annualize the costs of Federal pay adjustment. The current number of personnel is 489, down from previous years.

PRESIDENT'S BUDGET

With respect to the overall budget, the President's budget documents indicate that you plan to hold nonsecurity-related spending growth to 1 percent in fiscal year 2008. To do that, you're proposing terminations and reductions in discretionary programs totaling $12 billion.

Since the President's budget came out before the fiscal year 2007 spending levels were finalized, we believe that you are essentially proposing level funding in fiscal year 2008 for nonsecurity-related spending.

The budget assumes dramatic reductions in many programs. The Center on Budget and Policy Priorities estimates that your budget for 2012 implies a cut of nonsecurity funding of nearly 8 percent in real terms below the 2007 level.

So-called mandatory spending, or entitlements, represent about two-thirds of the budget. These programs don't require congressional action on an annual basis. We'll be interested in discussing with you what proposals are in the President's budget regarding entitlements.

I look forward to discussing your budget proposal, exploring a few other areas, and I turn to Senator Nelson, if you'd like to make an opening statement.

Senator NELSON. Thank you, I'll just turn to questions, Mr. Chairman.

Senator DURBIN. Thank you. Mr. Director, the floor is yours.

OPENING STATEMENT OF ROBERT J. PORTMAN

Mr. PORTMAN. Thank you, Mr. Chairman, very much, and I appreciate your taking the time to have me here with you today. Also, thank you, personally, for being willing to meet with me and talk about some of the issues that are of concern to you and the subcommittee. Mr. Brownback, the ranking member, also agreed to meet with me, which I appreciate.

As you noted, OMB has submitted a disciplined fiscal year 2008 budget request. When rent and other costs are included, the total budget—as you noted—amounts to about $79 million, which is a 2.7 percent increase, compared to 2007.

As the subcommittee knows well, we've been operating under relatively tight budgets, annual increase of about 1.8 percent per year since 2001. Our budget, as you know, is almost entirely made up of salaries and expenses, so the only significant means to achieve savings is through reductions in staffing. And we've done that, to accommodate our funding levels, we've reduced OMB staff from 527 positions in fiscal year 2001 to 510 in 2004, and today, 489.

The budget we proposed to you, as the chairman and I had a chance to discuss, does allow us to maintain our high-caliber workforce of 489 employees going forward, incidentally, over 90 percent of whom are career civil servants, not political appointees.

We believe OMB can continue to deliver high-quality performance, and fulfill our many core responsibilities at these staff levels, or full-time equivalents (FTE), of 489.

The best known of our responsibilities is the preparation of the budget, but as the chairman has noted, we also have responsibility for a lot of other things, including oversight of the agencies regarding budgets, management, legislative proposals, regulatory reforms, procurement policies, and other issues. I believe our dedicated staff are performing their responsibilities in an outstanding manner, within the constraints of a tight budget.

If I could, just briefly, draw your attention to the management side of our responsibilities, because I know the subcommittee has an interest here—we are focused in making Government more effective through five specific initiatives: strategic management of human capital, competitive sourcing, improved financial performance, enhanced and expanded electronic governance, or e-Gov, and finally, budget and performance integration.

And that last one, integrating budget and performance, we've made some interesting progress recently to ensure greater Government accountability. Last year, we launched a website called ExpectMore.gov. It provides information on programs that have been assessed for effectiveness, using what we call the PART, the program assessment rating tool. With this website, Congress and the public now have an unprecedented view into which agencies and programs are working, which are not, what steps are being taken to improve them—it's part of an ongoing effort to provide greater transparency, hold ourselves accountable, and demand results.

With the new and improved version of this website launched with the 2008 budget a couple of months ago, we now have program-level information on about 1,000 Federal programs, representing about 96 percent of Federal spending, $2.5 trillion worth of spending.

It's a really great resource. And, I encourage members and staff who haven't already checked it out to do so, ExpectMore.gov.

Unfortunately, in recent years, Congress has included provisions in appropriations bills that slow our ability to make continued progress on the President's management agenda, particularly in the area of competitive sourcing, and in e-Government. Next week, Mr. Chairman, we plan to submit to you and others who have an interest, a report that updates you on how competitive sourcing is working from our perspective, I'll give you a couple of highlights of the report.

One, new efficiencies and performance improvements that have resulted from competitive sourcing are expected to produce more than $6 billion in savings over the next 5 to 10 years. Second, we have only competed activities considered commercial, and not inherently governmental, and incidentally, we've only competed about 3 percent of governmental activities. Third—and this surprises some folks who have not kept up to speed on how this works, Federal employees have fared well in these competitions. If you look at the 2003–2006 data, 83 percent of the work competed, Federal employees have received, they've won the competition. This last year, the number's even a little higher than that. So, for the

most part, it's Federal employees who are winning these competitions, and again, we've only competed about 3 percent of governmental activities.

With regard to the overall budget, the chairman talked about, the President's fiscal year 2008 budget shows how working together with Congress, we can continue to reduce the deficit, in fact, we reduce it every year in our budget, balancing the budget by 2012, while keeping taxes low, and meeting our Nation's top priorities. It builds on the progress we've made the last couple of years where, as you know, we've actually had a $165 billion reduction in the deficit—working with Congress on restraining spending, and continuing to have a strong economy.

One part of the 2008 budget, I think is particularly interesting to this subcommittee is its jurisdiction, which is a very interesting jurisdiction as I've looked at it, is in the tax gap area. I know this is something the Finance Committee is also looking at, but, if you're interested, I would be pleased to talk to you more about enhanced compliance efforts, and legislative changes that we put in our budget this year to deal with the tax gap.

A balanced budget by 2012 would be a major accomplishment, but it would be short-lived without addressing the long-term budgetary challenge. And, the chairman just mentioned it, and that's the unsustainable growth in entitlement programs. As appropriators, you are well aware that mandatory spending is overwhelming the rest of the budget. In the space of four decades, mandatory spending has grown from about 25 percent of our budget, to over one-half the budget. And again, the chairman used the figure of two-thirds, when you include interest on the debt, it's getting up toward that level, so it's the fastest growing part of our budget, and it's an area we need to focus on, as Republicans and Democrats.

PREPARED STATEMENT

So, Mr. Chairman, thank you very much for having me before this important subcommittee. I believe OMB is staffed with some of the highest quality and most dedicated people I've ever worked with, and the most dedicated professionals in the Federal Government. As noted, we are recommending a disciplined budget for OMB that continues to provide the necessary resources to serve the President and meet our duties to Congress and to the American people. I look forward to working with members of the subcommittee as we move forward with the appropriations bill. Again, I thank the subcommittee for its time, and I look forward to your questions.

[The statement follows:]

PREPARED STATEMENT OF ROBERT J. PORTMAN

Chairman Durbin, Ranking Member Brownback, and distinguished members of the Subcommittee, I am pleased to be here today regarding the President's fiscal year 2008 budget request for the Office of Management and Budget.

OMB'S BUDGET

The Office of Management and Budget has submitted a disciplined fiscal year 2008 request for our agency. When rent and other costs are included, OMB's total

budget request amounts to $78.8 million—a 2.7 percent increase compared to the fiscal year 2007 continuing resolution.

To achieve spending restraint, I have asked OMB to pursue cost savings wherever possible. As the subcommittee is aware OMB has been operating under very tight budgets. Over the past 6 years, our budget has increased by an average of 1.8 percent per year and over the past four years it has increased by an average of only 1.2 percent. Our budget is nearly entirely comprised of salaries and expenses and our only significant means to achieve savings is through reductions in staffing. To accommodate lower funding levels, we have reduced OMB staff from 527 positions in fiscal year 2001, to 510 positions in 2004, to 489 positions in 2007.

The budget we have proposed for OMB will allow us to maintain a workforce of 489 positions, well below the levels we had in 2001. We believe OMB can continue to deliver high-quality performance and fulfill our many important responsibilities at these staff levels.

The best known of OMB's responsibilities is the preparation of the President's annual budget. In addition, our responsibilities include oversight of the other agencies regarding budgetary matters, management issues, the Administration's legislative proposals, regulatory reforms, procurement policies and other important matters. We work to ensure that all the Administration's proposals in these areas are consistent with relevant statutes and Presidential objectives. I believe our dedicated staff are performing their responsibilities in an outstanding manner within the constraints of a tight budget.

MANAGEMENT/EXPECTMORE.GOV

I want to briefly draw your attention to one of our important responsibilities, implementing an aggressive management agenda. This effort, led by the OMB deputy for management, Clay Johnson, is making the government more effective by focusing on five initiatives. Those initiatives, all launched in 2001, are (1) strategic management of human capital, (2) competitive sourcing, (3) improved financial performance, (4) expanded electronic government (e-gov), and (5) budget and performance integration.

To ensure greater government accountability, last year we launched a new website: ExpectMore.gov. This site provides information on programs that have been assessed for effectiveness using the Program Assessment Rating Tool, commonly referred to as the PART. With this website, Congress and the public now have an unprecedented view into which programs work, which do not, and the steps being taken to improve them. It's another way we are providing greater transparency, holding ourselves accountable—and demanding results.

With the new and improved version of this website launched with the 2008 budget, we now have program-level information about the performance of nearly 1,000 Federal programs representing about 96 percent of government and $2.5 trillion of federal spending. I urge Members and staff to check out ExpectMore.gov.

Unfortunately in recent years, Congress has included provisions in appropriations bills that slow our ability to make continued progress on the President's Management Agenda, particularly in the area of the competitive sourcing and E-government. We would like to work with you to address your concerns and to avoid provisions that would restrict the progress of the management reforms.

FISCAL YEAR 2008 BUDGET

I would also like to take a moment to review the President's entire fiscal year 2008 budget, which we submitted for your review five weeks ago. Our 2008 budget proposal shows how working together we can reduce the deficit every year and balance the budget by 2012, while keeping taxes low and meeting our nation's priorities. It builds on the progress we've made over the past two years, which has led to a $165 billion reduction in the deficit.

We have been able to make progress for two primary reasons: first, because we have been blessed with a strong economy that has generated record revenues and, second, because the Congress, working with the President, has done a better job of restraining spending, especially keeping non-security spending under inflation for the past three years. It is exactly these elements—a solid economy and restraint on spending—that can now lead to balance.

The 2008 budget continues to support growth, innovation, and investment by making permanent the President's tax relief, which would otherwise expire in 2010. Since the tax relief took full effect in 2003, we have seen strong and steady job growth—with the creation of more than 7.6 million new jobs. After 2003, Federal revenues also surged—hitting record levels over the past two years. With solid economic growth, our total receipts are now slightly above the historical average of 18.3

percent—as a share of the economy—and we project receipts remain at or above the historical average for the five-year period.

The 2008 budget demonstrates we can achieve balance by 2012 without raising taxes. In addition, we plan to more effectively and efficiently collect the taxes owed through new initiatives to address the tax gap. First, we improve the effectiveness of the IRS' activities with a $410 million package of new initiatives to enhance enforcement and taxpayer service and to improve the IRS' information systems. Second, we include in the budget 16 carefully targeted tax law changes that promote compliance while maintaining that important balance between the burden being imposed on taxpayers and our shared interest in collecting taxes owed. The budget also includes other investments in program integrity efforts to generate additional savings.

While restraining spending overall, the President's budget also provides new resources for key priorities. It increases funding for our national security to combat terrorism and protect the homeland. It includes new policies to address issues of concern to America's families, including educating our children, access to affordable health care, and reducing energy costs. The 2008 budget also proposes to hold the rate of growth for non-security discretionary spending below the rate of inflation. We believe we can address our nation's top priorities at this level of funding.

A balanced budget by 2012 will be a major accomplishment, but will be short-lived without addressing our long-term budgetary challenge: the unsustainable growth in Medicare, Medicaid, and Social Security. Mandatory spending is overwhelming the rest of the budget. In the space of four decades, mandatory spending has grown from 26 percent of our budget in 1962 to 53 percent of our budget in 2006. We must begin the reform of these programs now in order to protect those commitments. Addressing entitlement spending is the right thing to do because small changes now have a big impact later.

CONCLUSION

Mr. Chairman, thank you for having me before this important subcommittee today. As noted, we are recommending a disciplined budget for OMB that still provides the necessary resources for this agency to serve the President and meet its duties to the Congress and the American people. I look forward to working with the members of this Subcommittee as we move forward with the appropriations bills.

I thank the Committee for its time, and I look forward to your questions.

STAFFING

Senator DURBIN. Thank you, Mr. Director, and let me ask you a few questions about staff. Have you had any difficulties recruiting, hiring or retaining staff at OMB?

Mr. PORTMAN. We have not had a difficult time recruiting. As you may know, OMB was determined by a magazine entitled Partnership for Public Service, as one of the best places to work in the Federal Government. And, I sometimes wonder about that, since the hours are long, and the work is hard. But, it's a good place to work, people like working at OMB——

Senator DURBIN. Is that your brother-in-law's publication, or is that——

Mr. PORTMAN. Actually, I've told people it really is reviewing the year before I got there, because I've been there for 1 year. We'll see what happens next year.

But, our FTEs are down a little bit right now, which is typical. After the budget cycle, we tend to have a drop off. We're about 5 percent down right now, from our budgeted FTE level, that enables us to do our work. We're down to about 470, instead of 489. So, we're down a little bit.

We just finished our recruiting, we broadened our recruiting this year, as you and I talked about. We had very good luck, so we're hoping to be able to, once again, attract a lot of high-caliber young people to OMB.

Senator DURBIN. What percentage of your employees are eligible to retire in the next 5 years?

Mr. PORTMAN. It's growing. I don't know what the percentage is. We do have our baby boom generation, of which I am a part, and I think you are, Mr. Chairman. Our workforce is getting to that point where they can look at retirement. We'll get you that number.

[The information follows:]

There are a total of 101 OMB employees eligible to retire by December 2012.

Mr. PORTMAN. It concerns me, though. And, again, we're not having trouble recruiting good people. I'm very impressed with the young people we've brought in over the last year since I've been there, and we've had good luck on the college tour and graduate school tour, most recently, but it does concern me we're going to lose a lot of great talent.

Senator DURBIN. Does your agency use student loan repayment programs for recruiting and retention?

Mr. PORTMAN. We don't—we haven't had to. But, because of the prodding by a certain Senator from Illinois, we are now looking into that and that may well be something that I'll be able to report to you on very soon.

Senator DURBIN. It is a program to use if you need it. The point was, we feel that we can attract and retain many young people who are burdened with student debt to public service and to the Federal Government. We use it in the Senate, pretty extensively, so, I don't want to impose this on you, this is not a requirement to get approved budgets through this Appropriations subcommittee, but——

Mr. PORTMAN. We think it's an interesting option, and we are looking at it very seriously.

CONSOLIDATION

Senator DURBIN. There's a proposal in the President's budget to consolidate a number of appropriation accounts within the Executive Office—the actual number of accounts to be consolidated is eight—into one large account called, The White House. This was proposed last year and was not accepted by Congress.

Why do you think it's a good idea to eliminate the separate accounts, and consolidate funding in one large account? Wouldn't Congress lose budgetary control and transparency? And, I might add, the Executive Office of the President has appropriations transfer authority in the annual appropriations bill, that allows transfers up to 10 percent. So, would you retain authority? In your 2008 bill proposal?

Mr. PORTMAN. Well, we—as you know—this has been a difference we've had with Congress. I think it's a good idea just for the efficiency and the best practices you can get by consolidating functions. I don't know how to answer your question in terms of the congressional impact, because I don't think—from what I know about it, and I must confess, I have not had the ability to talk to you or others about what you view as your current ability to influence some of these functions, but I don't think it will make a key difference. And, I think, the key difference is, your level of interest,

and oversight. And, I think the White House Executive Office of the President would be very responsive to you.

But, it's an effort to consolidate, it's an effort to gain efficiencies, and again, to focus on best practices, and all of the different elements within the Executive Office of the President.

Senator DURBIN. My colleague, and ranking member Senator Brownback of Kansas has arrived. I know he had a bill pending on the floor, so I'm going to give him an opportunity now if he would like to either make a statement or ask a question, if it's all right with Senator Nelson.

Senator BROWNBACK. Thank you very much, Mr. Chairman for doing that, thank you for allowing that.

Thank you to my colleague from Nebraska for allowing me to step forward.

BALANCED BUDGET

Mr. Director, thanks for being here at the subcommittee today. We've had a chance to visit on some of these issues in the past. I do want to get a thought on record from you, if I could. Your comments would be helpful about ways to be able to get us to a balanced budget, and change the system in a way that will produce more balanced budgets in the future.

You and I have both been in the House of Representatives, and working on these issues in previous times, and we were able to get to a balanced budget in the past. It seems like to me, we were able to do that mostly by producing growth in the economy, and less by restraining spending. Yet, now we're at a time, we're getting some growth in the economy, although that economy appears to be slowing, we certainly don't want to increase taxes at this point in time. But, how would you systematically put in place programs or systems that would restrain the growth of Federal spending? If you had a chance to look at that as OMB Director, and I'd really like to get your thoughts on how you view that, and then I want to run an idea by you that I've been pushing on this issue as well.

Mr. PORTMAN. Well, thank you, and again, I—before you got here, I said that I appreciate the fact that you and the chairman were willing to meet with me and talk about some of the subcommittee issues individually. This is one of the issues you raised then, and you and I talked a little about your legislation, which I'm happy to address in a moment.

Let me make a bigger point, if I could, though. You and I also talked about the growth of the entitlement programs, and the fact that they are becoming a bigger part of our overall budget, and to get to balance, in my view, it's necessary—not so much short term—where we can get to balance, working together, restraining domestic discretionary spending, looking at the economic pro-growth policies. But, over the longer haul, 10, 15, 20 years, the way to stay in balance, as you say, must include looking at the unsustainable growth rate, because it is 6, 7, 8, 9 percent growth rate of these important programs, like Medicare, Social Security, and Medicaid. Otherwise, it's very difficult to imagine us being able to stay in balance without huge tax increases which would result, I think, in a detriment to the economy.

Within the roughly 19 percent of the budget that is the discretionary spending on the domestic side, particularly, there are things we can do. And, I think, looking at the performance measures that I talked about before you arrived that we're doing now with ExpectMore.gov, which is our website where we put up the assessments of 1,000 Federal programs, about 96 percent of our spending. We're making progress, we think, in determining which programs work, which don't, and spending the Federal dollar in the most efficient way possible.

We also have, as you know, proposals for a commission that would look at waste, fraud, and abuse in our budget, and then we have a commission called the Sunset Commission, which actually has a lot in common with your CARFA proposal, the Commission on Accountability and Review of Federal Agencies.

Senator BROWNBACK. If I could, the CARFA bill was included in the budget resolution that the Senate approved before the Easter break, and I hope it's something that the administration could come out supporting in an official position. It takes the BRAC process—the military base closing commission process—and applies it to the rest of Government. And it's my conviction that we will not be able to restrain the growth of Federal spending if we use the current system, and just keep the current system in place. So, we need a systems change.

You have a sunset proposal that you put forward—and I think that's a good idea, and a good way to go as well, so that there regularly is a sunsetting of bills.

And, Mr. Chairman, I might note, I think this is a Republican and a Democrat proposal. Under either scenario, either party in control, we really need to be able to cancel programs that aren't performing. And, we've not been able to find a successful way of doing that. And, it's a great frustration to all Americans—whether you're liberal or conservative—I get people raising a number of programs that have been seen as conservative programs that they're saying, "Well, they're not producing."

Well, here would be a systems way that you could cancel programs that aren't producing results on an objective basis, and then force the Congress to vote.

And, that's what I'm after, is getting that systems change, because I think we're just showing that the system is built to spend, and we need it to be built to save, particularly in entitlement programs.

MEDICARE AND MEDICAID

Before my time runs out—on Medicare and Medicaid, in particular—what is it that you want to target to be able to get into more sustainable growth patterns, as you look at those two big entitlement expenditure programs?

Mr. PORTMAN. It's a great question, and probably the most critical budget question is healthcare and the entitlements, that combination. Not that Social Security isn't a priority, it is, but the fastest growth is actually in the healthcare side, and that's where—as you and I talked about—you see the greatest unfunded obligation, $32 trillion in Medicare alone over the next 75-year period.

Two things, I guess, one is the cost of healthcare. Because, we know more and more about how healthcare drives Medicare and Medicaid, and vice versa, that's such a big part of our healthcare system. And this—as you know, the President's proposed in the budget some changes, with regard to the standard deduction, with regard to litigation in the healthcare area, and other things that are focused on getting the costs down, and keeping the quality up, in terms of healthcare.

Second, is with regard to the programs themselves. We have some specific proposals in our budget, they tend to focus on two things. One is rightsizing the amount of Federal reimbursement to providers, the so-called market basket change that we have, a 0.65 percentage point change—it's relatively small—but it has larger out-year impacts.

And then, second, is more income relating, which is a technical term for means testing. Telling seniors that if they are in part B or part D, that their subsidy under those programs, if they make over a certain income, would be, over time, effectively reduced. Right now, if you make over $80,000 a year, $160,000 as a couple, you begin in part B to see that Federal subsidy reduced. We would like that in place under our budget proposal, and also apply it to part D.

This has been a controversial proposal in the past—I'm sure it still is controversial—but actually, I've found in talking to Republicans and Democrats alike—that Members are willing to look at this, to listen to come of these ideas. These are our ideas, we're eager to hear ideas from other folks. By the way, those two proposals alone reduce that unfunded obligation by $8 trillion over the 75-year period. And again, we do not have a monopoly on good ideas, here, they're tough to come by. It's a difficult area politically, as well as substantively.

But, we look forward to working with Congress on that, because you're right—those are key elements to not just getting to balance, which I believe we can do, working together, and I think we can do it in the next 4 or 5 years. But how do you sustain that over time without a huge tax burden on the economy?

Finally on CARFA, your proposal, we do share your goals on this, and we want to work with you to get it enacted, we think it's good policy.

Senator BROWNBACK. Thank you.

Thank you, Mr. Chairman.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Good afternoon. I want to thank you, Chairman Durbin, for your leadership of this new subcommittee. I look forward to working together with you during this coming year as we make funding decisions and provide oversight to the various agencies within this subcommittee's jurisdiction.

Director Portman, thank you for appearing before our subcommittee today. I look forward to hearing the details of your fiscal year 2008 budget request and the key efforts that your agency will be undertaking this year.

Looking at the President's budget, I am pleased that it assumes the continuation of the recent tax cuts, which have helped our economy rebound from recession to its current robust health. I am also encouraged that the President is projecting a balanced budget by 2012. I believe that the only way we can continue on a course toward balanced budgets is by growing the economy through lower taxes and by restraining federal spending.

Lower taxes spur economic growth, which means more jobs, healthier businesses, and a better fiscal outlook for all Americans. Although the economy is strong and jobless numbers are down, I believe we have more work to do. We should continue to reduce the deficit and make the recent tax cuts permanent, especially the death tax which overly hurts small businesses and family farms.

Mr. Portman, you note in your testimony that the Administration plans to direct additional resources to close the so-called "tax gap." Certainly, we must ensure that taxes which are owed are collected. However, I remain concerned that our tax system is overly complex, complicated, and burdensome. Americans spend roughly $157 billion each year in tax preparation to ensure they do not run afoul of the IRS. The system is in desperate need of reform. And as tax day is right around the corner, I must reiterate that I support a flat tax concept which simplifies tax preparation, applies a low tax rate to all Americans, and respects the special financial burden carried by American families raising children. One reason we have a "tax gap" may be that our tax system is so complex and convoluted that taxpayers cannot even figure out what they owe.

Mr. Portman, I look forward to hearing your testimony this afternoon. Your agency has a key role in prioritizing how federal discretionary funds will be allocated. This is no small task. There are many programs and activities worthy of federal support. But we must always temper those funding needs with the goal of a balanced federal budget. We must be prudent stewards of American's tax dollars and not pile up debt for our children and grandchildren to pay. Just as American families must make difficult budget decisions about their hard-earned dollars, we must ensure that we are spending the people's money wisely. I will have some questions for you about how the federal government is spending taxpayers' dollars and how we can improve efficiency in government. From personal experience, I can tell you that few things are more upsetting to my Kansas constituents than to see wasteful government spending. Kansans often say to me, "I don't mind paying the taxes I owe, but it is infuriating to see my hard-earned money being wasted. If I am going to work hard to earn money, I want what I have to pay in taxes to be spent wisely."

So thank you for appearing before this subcommittee today, Mr. Portman. And thank you, Mr. Chairman, for your leadership of this subcommittee. I look forward to working with you this year.

Senator DURBIN. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman.

ADMINISTERING EARMARKS

Director Portman, thank you for coming before the subcommittee today. Earlier we talked about the earmark issue, and the way in which they are administered by agencies. And, as you know, I am interested in this, and more than 1 month ago, before the database was finalized, I communicated with you, my ongoing interest in collecting information on the degree to which agencies assess fees on congressionally directed funds before they're allocated to the congressionally direct recipient. In which I stated my desire to see this information posted on OMB's website.

I think the information would be useful, not only to OMB, but to Congress and the American taxpayer, in the spirit of transparency, to provide the full picture of exactly how this money is expended. Unfortunately, I only received a short response to my letter 2 months after I sent it, and I know we just visited about that, but the sense I got from your letter is that it hasn't really come down before others, other decisionmakers at OMB for consideration, and I'm wondering if you can give me your thoughts about developing information about what the agency's charge for the administering of earmarks, and where they have authority to do it, and where they don't have authority to do it, but they just have assumed authority.

As a former Governor, I can tell you, my agencies never assumed any authority they didn't have, and get by with it. But, we're see-

ing agency after agency, ostensibly, based on the information they've reported to us, skimming or marking down earmarks before they are actually directed out to the congressionally mandated recipient. Earmarks being skimmed or marked down to the tune of 1 percent, up to 5 percent, or who knows what percent? Department of Defense said they couldn't even give us an answer. This is unacceptable. You cannot run a Government if you can't control the Government, and these appear to be—at least to me—in many cases, absolutely outside the budget, off-budget, if you will. And, it's unacceptable. I wonder if you might give me a response.

Mr. PORTMAN. Well, first, as I have said to you, I think it's a very helpful addition to the transparency that we're now providing in terms of earmarks. Also, as you know, we're in the process of working with the agencies on another challenge, which is implementing what we strongly support, which is the Coburn-Obama transparency on grants and contracts. In theory, I think, the difference between our earmark database, which has just gone up recently, and the new database we're working on, which would be the grants and contracts, should be the administrative expenses, there may be some other issues there, technical issues we have to work through. But, that should be very interesting information, we're eager to work with you to supply that information.

As you know, some of these agencies have a statutory requirement to provide for some administrative expense as they deliver the funds. So, for instance, in the research area, it's a 4 percent number. I don't know that that's inappropriate—that's something Congress has determined is appropriate. I don't know what the right number is, but for an agency not to take on any administrative expenses when there's a number of earmarks in an area, does provide a hardship for them and in fulfilling their other responsibilities Congress has given them.

So, there probably is, in some cases, a number that is appropriate, that is statutory. In other cases, that may be something Congress wants to look at. And, in some cases, as you say, there is no statutory requirement. So, agencies have used, past practice has been to, for certain agencies to establish a certain number for a certain type of program, that's something that we would like to look at. So, I'm glad you brought it to our attention.

Senator NELSON. Well, I might bring something to your attention too, just, in one case, the administration on aging program innovations, said that they withheld up to 1.3 percent to cover costs related to grant peer reviews, as well as unexpected costs—whatever those would be—payments for cancelled obligations, secretarial transfers, cited statutory authority left blank, other explanation of authority or reasons for a fee assessment, left blank. Food and Drug Administration (FDA), food technology evaluation—they say there's none by the FDA, the Army, which handles the payment for FDA, charges a 6-percent administrative fee. I think we really do need to get a handle on this. As I say, you can't really budget effectively, if you don't know what your agencies are charging, and/or if they don't have any authority—statutory authority, or as part of the earmark, receive authority for withholding some amount for the administration of that earmark.

This is something that, generally, is budgeted, because a number of the agencies went through and said they don't—they budget this in their overall budget, and they don't take anything for the administration of earmarks. And, it's skimming, if there's no authority, well-intentioned as it may be, or it's marking down, well-intentioned though it may be, but it's without apparent control, or under the authority or control of OMB. And yet, their budget comes out for a lower amount than what they're actually receiving in terms of money coming in. And, I don't know that that would create a slush fund within an agency, but one has to wonder how they match their expenditures to what they charge for that fee for administering the earmark.

Mr. PORTMAN. No, I think it's a very good point, the agencies, as you know, over the last 10 years have had almost a quadrupling of earmarks. And, so probably for some of these agencies, this was not a very big deal, in terms of their overall budget, 10 years ago, and they are making that adjustment. The House and Senate have come forward with new rules for increased transparency,. Chairman Obey has proposed that earmarks be cut in half. There will be fewer earmarks, I believe, just as there were this year as compared to last year, and 2006 as compared to 2005. But this is an issue that I do want to get on top of, try to figure out, again, as we're asking the agencies to go to this next level on the Coburn-Obama grants and contracts, if we can also get this very specific information. And, thank you for your willingness to share the Congressional Research Service (CRS) report that was provided to you. I think that'll be very helpful to us, as well.

Senator NELSON. Well, thank you. It sounds like things happen a little faster if there are a couple of names on a bill, so I'll get one of my colleagues, and we'll get something "Nelson-so and so" to help you have the authority to do it. And/or the urgency might be expressed.

Thank you very much, Director Portman.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Nelson.

EARMARKS

Director, let me ask you about earmarks. You sent out a memorandum to agencies and departments on February 15 about earmarks and how they were to be treated. Would you tell us what you were trying to accomplish with this memo, and what is your policy going to be about congressional earmarks in the future? Do you plan on maintaining an ongoing database on earmarks, and tell us a little bit about your new website, FederalSpending.gov.

Mr. PORTMAN. Well, thank you, Mr. Chairman. Let me distinguish, if I could, between the February 15 instruction, and the January instruction—I believe it was on January 25, so it preceded Senator Nelson's letter to me. We gave instructions to the agencies to compile earmarks for the purpose of the database, that was to be sure that the cut in half goal had a basis that was fair, frankly, that we were accountable, so that when Congress came to us with future appropriations bills, we had a basis that people could agree upon. It's also an opportunity for Congress to look at our definition, which it turns out, is very close to your definition in the Senate-

passed bill and the definition in the rules in the House, and to look at the individual earmarks, to see if you think they're appropriate or not.

So, that is up—that database is based on the January guidance that we sent out to the agencies. To your question as to whether we plan to continue the database, the idea was to establish a database as a benchmark. We chose 2005. We thought that was the fairest year. It happened to have been the peak of earmarks. It also happened to be the year in which all of the agencies were represented. As you recall, in 2006, the Labor/HHS bill did not include the earmarks it had previously included. From a congressional appropriations point of view, we thought 2005, frankly, was the fairest and the most comprehensive benchmark to use.

We'll continue to monitor this, now, going forward. With regard to the guidance on February 15, that was with regard to the 2007 spending. And, what we were trying to do there, was not to establish any new guidance from OMB over and above what was in your 2007 continuing resolution. That was an attempt on our part, simply to take your 2007 guidance that you had provided us, through your continuing resolution, and make it very clear to the agencies what it meant in terms of their interaction with Congress for 2007. And, I think that's been fairly well-received by the agencies. Incidentally, I think the agencies have done a pretty good job on the earmarks. They didn't get everything into us on a timely basis, but it was a huge project, and we think this transparency will be helpful going forward.

Senator DURBIN. So, what is this new website?

Mr. PORTMAN. FederalSpending.gov is the name of the site where the Coburn-Obama database will be posted, so that's a third transparency issue, in addition to ExpectMore.gov and the database on earmarks, that will be up and going, by law, by the end of this year. We're making pretty good progress on it, and we're hoping to be able to have some preliminary data available before that time. But we believe at this point, Mr. Chairman, and you should hold us accountable for this, that we will be able to do this in a timely manner, per the statutory requirement.

The database on earmarks is on OMB.gov and if you go to OMB.gov, and then you go to "earmarks" that's where you will find that database.

OFFICE OF INFORMATION AND REGULATORY AFFAIRS

Senator DURBIN. One of my favorite agencies in OMB is the Office of Information and Regulatory Affairs (OIRA). This is kind of like freakenomics to the 10th power, and it apparently holds a very high place in the pantheon of your administration. So much so, that the President would make a recess appointment of Ms. Susan Dudley to follow, I believe, John Graham, who was one of the earlier people appointed.

It seems that, from an outsider's point of view, that you're attempting to take away the regulatory authority of agencies, or circumscribe it, by vesting that authority in this office. That regulatory authority was created by legislation in each of these agencies, and it would seem that your goal is to supersede, or at least monitor, that authority, as it's being exercised.

It also seems that there's—God forbid—politics involved here. I'm wondering if you could explain to me why it's a good idea to put a political appointee in charge of a regulatory office in each agency, as you have proposed. Why do you want to further centralize regulatory power in OIRA, and shift it away from individual agencies?

Mr. PORTMAN. First of all, with regard to OIRA, you're right, it's a very important entity, they have an important responsibility, because they do look at the regulations and rules—this has been true in previous administrations, as you know, as well as this one. They apply a benefit/cost analysis, ensuring that the agencies have gone through the proper process that Congress, incidentally, has asked them to do. In some cases, a risk assessment, depending on the kind of regulation or rule.

When I first got to OMB, as you know, there was no Administrator of that Office, because John Graham had left, and it was open. We then nominated Susan Dudley who, I believe, is very well-qualified for this position. She has worked, among other places, at OMB, other agencies, and has a good background. I think six of the former OIRA Administrators, Republican and Democrat alike, had very kind things to say about her in their letter to you as someone who was professional, and someone who could do the job in a fair, nonpolitical way.

We did try to go through the normal process, she was not able to be confirmed. So, for the first time in 1 year, since I've been there, we do now have, as of the recess appointment, a head of the Office who is a political appointee. I think she'll do a very good job, and I hope you get a chance, Senator, to meet her and look at her work. I think you'll find, as you look at it objectively, that she will do a fair, balanced job. That's certainly our idea.

In the meantime, Steve Aiken, who is a career civil servant at OMB, who previously was in the General Counsel's Office, served in an acting role there, and he did a terrific job. And, so it's my hope that the good work Steve was doing continues. In other words, I don't view this as a political responsibility, I view it as OMB's role to look at regulations and rules, and make sure they are consistent with both the congressional dictates that we live under, including coming up with the right analysis of their impacts on both the benefits side and the cost side, but also consistent with the President's policies.

Senator DURBIN. Are you familiar with Ms. Dudley's background? Spending the last 3 years as director of regulatory studies for the Mercatus Center on the campus of George Mason University? Mercatus Center, founded by corporate interests, endowed by large corporations, free market-oriented foundations, and leaders of the corporate world?

Mr. PORTMAN. Yeah, I'm familiar with her background, generally, and her résumé. Again, she was actually nominated about 1 year ago to Congress. I think the formal announcement to Congress was a little more than 8 months ago.

Senator DURBIN. And were you aware of the fact that in that capacity she opposed improved standards for airbags in passenger vehicles?

Mr. PORTMAN. I'm not aware of that specific issue.

Senator DURBIN. This is where this obscure little agency starts worrying me. Because someone from her background is now going to judge issues about health and safety. And, make calculations on cost benefits that seem like they're very scientific and very mathematic, which time and again always tend to hurt the consumer and help those who are, frankly, pretty well off in this country. It's a mindset that seems to drive this view toward regulation. So, I hope you'll understand why some of us were a little bit upset that she was put in by recess appointment, into this critical area and we're going to be watching it carefully.

Senator Brownback.

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

SOCIAL SECURITY

Director, I want to ask a couple of specific questions on areas of funding that portend on big policy issues coming up. We're considering a major immigration bill. I hope we're going to be able to move one forward. The President talked a lot about it. My colleague and I are both serving on the Judiciary Committee and hopefully this is one we're going to be considering, and moving forward with.

There was an article that appeared March 29 this year in the Washington Times talking about uncredited earnings into Social Security. And, they put a big number on the amount of money going into Social Security from uncredited, or what would probably be undocumented people working in the United States. They said, "In 2004, uncredited earnings Social Security tax payments that can't be matched to valid Social Security numbers totaled $65 billion or about 10 percent of the programs' total income."

They lead the story by saying, "Uncredited contributions to Social Security grew by nearly $300 billion, from 2000 to 2004." The article says, "A giant increase attributable mostly to illegal aliens using erroneous Social Security numbers."

I wanted to ask you about this because if these numbers are accurate, there's a significant policy issue, financially, that's going to be happening to the country. Either we get the situation under control on undocumented workers, or nothing happens. Either way, you've got a big number that's involved here in Social Security and Social Security's future.

Are you able to put your finger on these numbers? Are you looking at these, in particular, relative to the policy debate we're having on immigration?

Mr. PORTMAN. It's an interesting question and there has been analysis by the Congressional Budget Office (CBO), as you know, of the costs of the program and it takes into account some of these payroll tax potential surpluses as well as the fees that would be paid and what the impact on the budget's going to be. And, in some cases it's been analyzed to be close to a wash. In other words that there be additional income coming in to the Government through fees and yet maybe some increase in some social service costs or some changes in some of these Social Security earnings.

On the specific report you're talking about, which I think is the Senior Citizen's League. Is that the group?

Senator BROWNBACK. It's a private group and I just, when I saw, these are eye-popping numbers and I wondered if these, if this is accurate or not?

Mr. PORTMAN. We don't know. You and I talked about this briefly at a previous meeting and I am trying to get more information about it. What I do know, at this point, is that the estimate is probably not accurate as to undocumented work. And, why do we say that? We say it because there are a lot of reasons that the name and the Social Security number (SSN) may not match SSN's file, the Social Security Administration's files, which is how they base the $65 billion figure.

My own sense is, there are probably a lot of undocumented workers in that group. But, to be able to determine which are undocumented workers, which are there because there's a typographical error, a name change due to marriage or divorce, or some other issue, is just impossible for us to determine with precision.

But, we are looking at it thanks to your raising it with me. I think it should be an important part of this debate. I tend to share your sense that this is, in large measure, due to undocumented workers who aren't claiming their Social Security.

Senator BROWNBACK. Well, it's a big number and it's going to have a big impact on this policy debate because it's a key part of the future funding of Social Security. And so, I would hope we could get tied down what that actual number is and what the amount there is.

WAR SUPPLEMENTAL

Mr. Portman, the President has stated that he will veto the supplemental if it contains a deadline for pulling out of Iraq. I'm curious to get your comments on the additional funding in this supplemental. Would you recommend that the President veto the supplemental over the level of additional funding that's in the bill?

Mr. PORTMAN. Yes, I would. And, the President has actually—in regard to the Senate bill as it came to the floor and the House bill—that the excessive and extraneous spending that's not related to the war effort would be the basis for a veto.

That number is, as you know in the Senate bill, I think just under $20 billion and the House bill over $20 billion. Some of that funding is nonemergency domestic spending that is not related in any way to security. Other aspects of the additional money is related to security in the broadest sense at least, because it has to do with returning war veterans, some of the Veterans Administration (VA) funding or DOD health money. Still other spending is related to Katrina where we do have, in our proposal as you know, a $3.4 billion request for the DRF, the Disaster Relief Fund, which is necessary for our ongoing commitment to Katrina.

So, there are various categories of funding in here, Mr. Brownback, but I do believe that it is excessive and extraneous. And, I believe that it is troubling, in the sense, that it is a big increase in domestic spending on top of the budget proposals from the majority in the House and the Senate, which have now been passed in their respective Chambers, which also increase spending in some of these same areas.

Senator BROWNBACK. Well, I agree. I think it's too much and it's something that the President should stand his ground on. Both on the amount as well as on the war timetable. That's not a wise decision and not a move that should be put in the supplemental bill, but I wanted to get your specific view.

MEDICARE PART D

Finally, and just if you have the quick numbers on this I would appreciate it, on the cost of Medicare part D. There was a lot of discussion when this policy issue passed that it was going to cost $400 billion and then there was some discussion that the numbers were cooked, and it actually should have grown to $600 billion and some even projecting it would be $800 billion. What has been the cost to the Government of this Medicare part D, the drug benefit program? I think in my State it has been very well received by senior citizens and people that are receiving this benefit. There was some problems in getting the program up and going, but overall it's been a very positive benefit. But, I want to know what the cost figure has actually come in at.

Mr. PORTMAN. It's good news. And, incidentally, to your customer satisfaction, looking here at a number of 80 percent customer satisfaction with part D, that's an average number, which is relatively high for Federal programs, as you might imagine. The actual costs are far lower than we thought they'd be. You recall when you and I were both serving in the House that there was dispute between the actuaries at Health and Human Services (HHS) and the Congressional Budget Office. And, we were relying on the Congressional Budget Office estimate. Others were saying, that in fact, HHS actuaries were more accurate and that number was far higher. It turns out the costs are a little below CBO's estimates. So the actuary estimate, I think it was $634 billion over the 10-year period, was relatively high. It's come in at closer to $445 billion, we believe, and that number shifts. In fact, it's gone down a little in the last year, that estimate. So, not only is the cost of the drug program down about 30 percent from our estimates when the President signed the Medicare Modernization Act, but it is even below where CBO was at the time.

Second, and I think this is more significant to your constituents, is that the beneficiary premiums are lower, about 40 percent lower than we projected. I remember at the time we said it would be $39 a month. Right now, we're at about $23 a month on the average monthly premium cost.

So, this is some good news. It's good news for taxpayers and the budget. From my perspective as OMB Director, it's good news in terms of our outlays, but it's also good because, as you say, most importantly it's a program that people are finding meets their needs and their costs are lower than projected.

Senator BROWNBACK. Thanks for mentioning that. And, it seems like it's one too, that we don't need major policy design changes at this point in time, that some of the cost control features are working, generally.

Mr. PORTMAN. The competition model seems to work because it's forced companies to compete for the business of millions of seniors.

Senator BROWNBACK. Thank you, Mr. Chairman.

Senator DURBIN. Mr. Director, let's take a little walk through the supplemental. Because I think the standard that you wanted to use was whether or not the supplemental spending request supported the war effort. Is that what you said?

Mr. PORTMAN. What I was trying to do is be balanced in my response, saying that I would advise the President to veto over the excessive and extraneous spending. Some of the spending is purely domestic. You've heard about a lot of this. If you listen to the media, they talk about the peanut storage and they talk about the spinach growers and so on. It's hard to justify any of that either as an emergency, in my view, or certainly as related to the war. Other spending is though, at least broadly defined, security spending in the sense that it relates, for instance, to VA.

Senator DURBIN. So, let's take peanuts and spinach off the table and take a little walk through the supplemental, as I can remember it. I don't have the litany here, but I can remember a lot of it.

We put in $2 billion over what the President requested, directly for the troops. And, a vote on the floor, an amendment offered by Senator Biden, supported on a bipartisan basis for the procurement of new vehicles that are safer for our troops when it comes to these improvised explosive devices (IEDs) and mines. So, would you consider that $2 billion to be extraneous and a reason for the President to veto the bill?

Mr. PORTMAN. I don't know. I'd have to look at the specific request. We, as you know, included funding for that in the original request and then in our amendment, which came about 3 weeks after the February 5 request, we actually amended it to include more funds for the so-called MRAPs, which are the vehicles that have been more successful in avoiding injury to our troops with roadside bombs.

So, we do think there's a need for more of those armored vehicles. The question has been how many can be produced, as I understand it. And, DOD has come up with their estimate of what the production possibility would be.

Senator DURBIN. But, would you call that wasteful pork-barrel spending, $2 billion for safer vehicles for our troops in Iraq?

Mr. PORTMAN. Not if it can be spent productively to provide the vehicles for our troops.

Senator DURBIN. Good. And, about $2 billion in there for the Veterans Administration, to put more people processing the paperwork for some of the veterans who are waiting over 1 year for disability evaluations. Put more money into hospitals for traumatic brain injury units, upgrade the para-trauma units, poly-trauma units across the board, more money for post-traumatic stress disorder (PTSD) for returning veterans where one out of three are suffering from this. Would you consider that $2 billion, roughly $2 billion for the Veterans Administration a reason for the President to veto the bill?

Mr. PORTMAN. Well again, I'd have to answer it by saying that we have worked closely with the Department of Veterans Affairs to come up with what is a fair number in our supplemental request.

And, with regard to our amendment, we actually added more for DOD health after the Walter Reed incident because——

Senator DURBIN. Well, there's another line item for that.

Mr. PORTMAN. Yes, we believe that there might be a need for additional funding even in this 2007 emergency supplemental and pending the results of the commission, wanted to be sure that funding was available.

But, I will refer you to VA's own analysis. And, their analysis is that the additional funding we're providing already is adequate to meet the very needs that you address. We have, as you know, about a 7-percent increase in VA funding for health, again, in our 2008 budget, over an 80 percent increase since 2001.

Senator DURBIN. I'm afraid the VA is notorious and the OMB is complicitous in low-balling the amount of money they need. It wasn't that long ago we came up with an additional $1 billion, after we'd been assured over and over again, it was unnecessary. It turned out it was necessary. I spent the last 10 days visiting VA hospitals, three separate hospitals. I can tell you what they need. They need resources and they need them now. These soldiers are pouring through the doors. They need help. They need specialists who aren't there. There's a lot more that we need to do. So, I hope you'll take a look at it.

Now, we have about $1 billion or more for military hospitals like Walter Reed. And, do you think that that $1 billion add-on to the President's budget request is reason for the President to veto this bill?

Mr. PORTMAN. Again, what we've done with regard to DOD health is added more funding, I think about $1 billion in our own request and then in the amendment added another $50 million, in relation to the Walter Reed issue to be sure that was, there was adequate funding available.

And, I would simply say, again, we need to have the adequate amount of funding to meet the needs of our returning veterans, our returning warriors. We're now in the process of an inter-agency group, that I happen to be part of, looking at this very issue. We're also, as you know, working with a commission co-chaired by Donna Shalala and Bob Dole. And, then finally DOD has started their own internal process. So, we do have some additional information coming forward that may change the administration's view on this. But, we have looked at this and that's why we included additional funds.

Senator DURBIN. You're very busy, and I don't want to hold you to this, but I've taken the time to visit these hospitals, in fact, Walter Reed within the last 10 days, to meet with the people there who I think are doing a wonderful job in their in-patient care. But, then to meet with some of these veterans, soldiers who've been there for long periods of time. And, I will tell you, if you want to go to war with Congress over whether we need more money for Walter Reed, we're ready. I think we need it for Walter Reed and military hospitals across this country. We are not prepared for what this war is sending back home.

Now, there's $3.1 billion in there for the Base Realignment and Closure Commission (BRAC). Do you think we should use the

money in this supplemental to pursue the stated goals and objectives of the Base Realignment and Closure Commission?

Mr. PORTMAN. Well, as you know, we felt strongly that should have been included in the 2007 bill and that's why we proposed it, and Congress chose not to deal with that in the long-term continuing resolution. In fact it's, really when you think about it, the only exception that was made. As a result, when we saw that it was reemerging as part of the emergency supplemental, and we don't believe that was the appropriate place for it, because it's not an emergency, it's something that should be handled in the regular course. We did send, as you know to you all, some offsets that totaled $3.1 billion to be able to cover that expense and to have it be within the emergency supplemental, but paid for. And, that's our hope. We think it's very important that it be done. In fact, we think it should have been done in the 2007 process.

Senator DURBIN. So, now I'm up to about $10 billion out of the $20 billion, and I've never mentioned peanuts and spinach.

We've talked about additional spending for the troops, to keep them safe, Veteran's Administration to deal with the hospitals, military hospitals, and BRAC. So, taken as a package, that $10 billion, do you think that's a good reason for the President to veto the supplemental appropriation?

Mr. PORTMAN. Again, it would depend on what the funding was for; we believe that we have funded a lot of these priorities already. We believe with regard to BRAC, it ought to be offset, we don't believe it's appropriate as an emergency. I don't think most Members of Congress do, either, incidentally, including the Appropriations Committees.

Senator DURBIN. Veteran's Administration is not an emergency?

Mr. PORTMAN. I'm talking about BRAC.

Senator DURBIN. Oh, okay.

Mr. PORTMAN. I'm talking about the BRAC funding.

On those other issues, we'd want to look at them. We'd want to look at, again, where we have already addressed those issues, what has changed in the interim time period. As I said, there is an ongoing commission on the DOD health, VA health issue because that is—as you know—an issue where there's overlap, and there's a legitimate concern about the handover from DOD to VA.

Senator DURBIN. There's about $1 billion in there for the 9/11 Commission recommendations for security at chemical plants, communications systems and the like—is this what you consider peanuts and spinach?

Mr. PORTMAN. Some of that, as you know, is in our 2008 appropriations request, in other words, it's in our budget request that we would hope you would deal with in the regular process. We don't view that as appropriate to be part of the emergency supplemental——

Senator DURBIN. Homeland security, not an emergency?

Mr. PORTMAN. Huge priority, and a huge priority for the President. And that's why we've increased funding fairly dramatically. The question is, whether this is the time and place to add to the needed funding for the troops for their protection, for their equipment, for their training. Frankly, items that are more appropriately handled through the normal process—where you have

oversight, where we have the ability to work through with other priorities, and where we have some rules applied.

Emergency spending—as you all know—is something that this Congress has, and the new majority indicated, they wanted to avoid, because it is not paid for, it is not subject to the rules, including the caps on domestic discretionary spending that you may well want to enforce. And the only question is, you know, why should this be done as part of this emergency funding request for the war?

Senator DURBIN. So, the President——

Mr. PORTMAN. I'm not saying it's a bad idea to proceed with pandemic funding for HHS for flu, or to proceed with funding for BRAC—we think these are all good things. They're actually in our budget. In the case of pandemic, I think we have roughly the same number you do—which is $100 million less than the House. But, we think this is an appropriate expenditure to be in the budget, and part of your normal appropriations process.

Senator DURBIN. So, the President has asked for funding for this war as an emergency spending item each year, which kind of belies the argument that we need more congressional oversight, but let's step aside from that.

Can you tell me, in previous years when these emergency spending requests for the war have been submitted to Congress, whether the Congress has added things that the President didn't include in his original request?

Mr. PORTMAN. I'm familiar—having come to this job about 1 year ago with last year's supplemental from an administration perspective. When I served on the Budget Committee prior to that, I'm also familiar with the fact that there's always additional pressure from Congress to add to any emergency supplemental—whether it's connected with, in this case, Afghanistan and Iraq, or not.

I'm also aware—as you know—that last year, by threatening a veto, as the President has done again this year, we were able to reduce the amount—in that case—by almost $15 billion under Republican majority. And, many of the items that were taken out of the bill were items that we're spending that the administration didn't oppose, but didn't believe were appropriate to be in an emergency supplemental, and were later dealt with in the regular appropriations process, that would be our hope.

This year, as you know, we submitted our war supplemental request earlier, and with far more detail, in response to the concern that you, and others, had expressed to us about timeliness and level of detail. So, with the budget itself, we sent a supplemental request—not just for 2007, but for 2008—we also provided account-level detail and for the first time, provided the justifications with that, hoping that 65 days ago when we did that, that Congress would have the ability to do the kind of oversight that I believe the Appropriations Committee has done.

Senator DURBIN. In previous years, has Congress added more money to the President's requested supplemental for the war in Iraq and Afghanistan?

Mr. PORTMAN. Has the——

Senator DURBIN. Congress added?

Mr. PORTMAN [continuing]. Added additional funding? Yes.

Senator DURBIN. And has the President signed the bill?

Mr. PORTMAN. Last year the President refused to sign it over his level, as you know. And his negotiations with Congress were successful, in the sense that the $15 billion in addition to what he requested was not included.

Senator DURBIN. So, you're saying the President has never signed an emergency supplemental bill for the war in Iraq that included any congressional add-ons?

Mr. PORTMAN. I think the situation last year was that the level of funding the President requested was maintained, and not a penny more. I'm not sure about the year before, or the year before.

In terms of the quality, you know, what was in the bill, the substance of the bill, I'm sure there were some changes, as there would be any year, in terms of the President's request that came from the Appropriations Committees.

Senator DURBIN. The administration's opposed to the additional funds for Hurricane Katrina that are included in the supplemental?

Mr. PORTMAN. We included additional $3.4 billion, which we think is adequate to make good on our commitments, in addition to the roughly $110 billion that you all have already appropriated for Katrina and Rita and the aftermath. We think that's adequate to meet the needs.

Some of the additional funding, in fact, the biggest part of it, as you know, is for levees—we do believe there's a need there, and a concern. We think it can be handled in the normal process. Most of that funding we don't believe can be spent in 2007, in fact, we don't think much—if any—of it can be spent in 2007. So, it would be more appropriate for us to deal with that as part of the regular appropriations process, but we're going to work with Congress on that.

Senator DURBIN. So, you would recommend the President veto the bill if there's additional Hurricane Katrina relief?

Mr. PORTMAN. Well, again, I don't know that I can answer that question without knowing which parts of that—there are three general parts of the Katrina add-ons as we look at it with regard to the levee funding. We don't think it's appropriate in the emergency context. Again, if Congress were to offset that funding with other reductions elsewhere, we would certainly be much more likely to be supportive.

Senator DURBIN. And as far as agriculture disasters, we haven't had an agriculture disaster bill for 2 years, and—as you know, having served in Congress—it was a traditional program, funded program, it was a program that was used whenever something happened of a disastrous nature, affected farming across America. So, do you believe that adding agriculture disaster funds in this bill is a reason for the President to veto it?

Mr. PORTMAN. Well, you were much more involved in the 2002 farm bill than I was, Senator. But, my recollection was that we were going to try to avoid these emergency supplementals by putting in place, not just the programs—marketing loan counter-cyclical programs—but also the Crop Insurance Program. And, I know you've heard from Secretary Johanns on this, but, you know, we believe that it is working, as intended, and we believe it is being re-

sponsive to the concerns in farm country, and that would be the preferred approach for us.

Senator DURBIN. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

PROGRAM EVALUATION

You've had an opportunity to show up before me a couple of times, I think, already this year, Director Portman, and I have complimented you on your efforts on implementing the legislation we passed from the Government Performance and Results Act (GPRA). In fact, as the various agencies show up in front of us, I look at your scorecard and ask about the programs that are rated ineffective, and ask them about those programs that are rated as "results not demonstrated."

I think it helps add to budget transparency, at least as far as I'm concerned, when we ask these questions. Sometimes it's legitimate reasons, perhaps, that they're terminating the program, and they just started in the process, and it's understandable. They've recognized the problem, so they're getting rid of it.

And then, in other instances, they just seem very defensive, and so, we kind of pick up on that, too.

Do you feel that this has added to the transparency in the budgeting process?

Mr. PORTMAN. I do, I feel strongly about it, and I know you've made a decision to leave the Senate, I hope you will pass along your GPRA and your scorecard interest to some of your colleagues, because it's an important part of the transparency that leads us to better Government.

I talked earlier with the chairman and other members who are here about the website, that I know you're very familiar with—ExpectMore.gov—and the fact that we now have 1,000 programs up that are subject to this scorecard, and we're looking at 96 percent of Federal spending now, which is an amazing resource, and so I thank you for raising it with the agencies. I do think it adds to the transparency. I think, as you say, sometimes there's a good reason for not scoring well on the scorecard, getting a red rather than a yellow or a green. Sometimes there's not. And one thing that we do is try to determine not just, whether they have met the standards—which we lay out, by the way, we ask the Agency, "What are your goals?" And then we judge them based on their goals. And that's all transparent.

As we develop the proposed funding level for the budget, we look at whether it's an appropriate governmental activity. In some cases the program could get all greens, but it isn't an appropriate Federal governmental expense or activity.

In other cases, you could have a lower score, but it's such an important program that we want to re-double our efforts to make sure it's working well for your constituents.

Senator ALLARD. I found it fascinating to look down through that ExpectMore.gov and I asked my question, well, what agencies are not on there? And, I notice there's nothing on OMB. Do you apply the assessment that you give to the——

Mr. PORTMAN. That surprises me, actually.

Senator ALLARD [continuing]. Other agencies to yourself, and do you have measurable goals and objectives?

Mr. PORTMAN. The ExpectMore.gov website includes PART analyses of programs. OMB does not have programs, which the chairman noted at the outset, so we don't have programs that are up there, but we do apply the President's management agenda to ourselves, which you can find on results.gov.

Senator ALLARD. But, you do spend taxpayer dollars.

Mr. PORTMAN. We do. And we apply all five categories of the President's management agenda to ourselves.

Senator ALLARD. But they're not public?

Mr. SHEA. Yes, they're public.

Senator ALLARD. Okay, so can we get a report from OMB?

Mr. SHEA. We grade ourselves on the scorecard——

Mr. PORTMAN. All right, I'm going to ask the Associate Director for Management, Robert Shea, to answer your question, if that's all right.

Mr. Chairman, is that okay if I have Mr. Shea——

Mr. SHEA. Yes, sir. OMB is assessed on the President's management agenda scorecard each quarter. So, we're assessed on our personnel management, financial management, information technology (IT) management, competitive sourcing, and performance management. We do have annual goals that collect data on and use to manage the agency. We don't manage programs, so we haven't assessed ourselves with the program assessment rating tool.

Senator ALLARD. So, how—if you were under that rating tool—how would you grade yourselves?

Mr. SHEA. We'd have to do that assessment first.

Senator ALLARD. Okay.

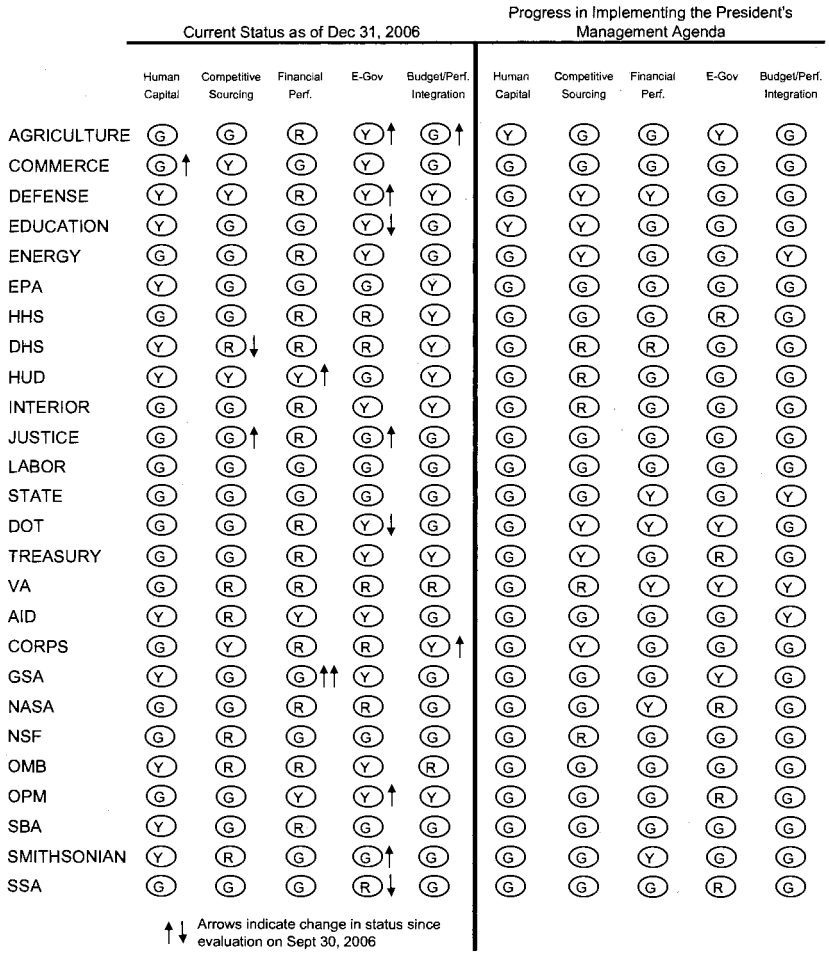
Mr. SHEA. And, we could show you how we're performing against our goals, and using the President's management agenda, how well we're managed.

Senator ALLARD. Well, Director Portman is liable to show up before me again. Will you have an answer when I ask that question?

Mr. SHEA. Yeah, we can give you a much detailed report on the quality of our management.

[The information follows:]

Executive Branch Management Scorecard



Program Initiatives Scorecard

	Current Status	Progress in Implementation
Faith-Based and Community Initiative:		
• Agriculture	G	G
• Commerce	Y	G
• Education	G	G
• HHS	G	G
• HUD	G	G
• Justice	G	G
• Labor	G	G
• VA	Y	G
• AID	G	Y
• SBA	Y ↑	G
Real Property Asset Management:		
• Agriculture	Y ↑	G
• Defense	Y	G
• Energy	G	G
• HHS	Y	G
• DHS	Y	G
• Interior	Y	Y
• Justice	Y	G
• Labor	Y	G
• State	G	G
• DOT	Y	G
• VA	G	G
• AID	Y	G
• Corps	Y	G
• GSA	G	G
• NASA	G	Y

Program Initiatives Scorecard

	Current Status	Progress in Implementation
Eliminating Improper Payments:		
• Agriculture	Y	G
• Defense	Y	G
• Education	Y	G
• HHS	R	G
• HUD	G	G
• DHS	Y	Y
• Labor	G	G
• DOT	Y ↑	G
• Treasury	R	Y
• VA	Y ↓	Y
• EPA	G	G
• NSF	G	G
• OPM	Y	G
• SBA	Y ↓	G
• SSA	Y	G
Privatization of Military Housing	Y ↓	G
R&D Investment Criteria	R	Y
Housing and Urban Development Management and Performance	Y	G
Broadening Health Insurance Coverage Through State Initatives	Y	G
A "Right-Sized" Overseas Presence	G	Y
Coordination of VA and DoD Programs and Systems	Y	Y

Senator ALLARD. Well, I think that—we want to make sure that everybody applies under that. Are there other programs that we are not evaluating that perhaps we should?

Mr. PORTMAN. The PART we're using to assess all programs over time—we've assessed 96 percent and we're making progress assessing the rest.

Senator ALLARD. Okay, well, if you happen to pick up on any that we're not assessing, I'd like to know why, if you would, please. Maybe the subcommittee would be interested in that, as well. I will be anxious to get your own evaluation back on this, Director. Thank you.

Mr. PORTMAN. One of the things I'm doing as Director is ensuring that we are meeting what we ask other agencies to do. And, I can tell you it's sometimes difficult, and, you know, we are going

for the green like everyone else is. So, it's something we do drive through the agency, just as other agency heads, too. Even though we do not have programs, we assess ourselves based on those five categories.

Senator ALLARD. I think it's helpful for other agencies to know you're doing the same, you know, everybody's living under the same rules, and what you expect of others, you're willing to live under, too.

Mr. PORTMAN. Right. I agree.

Senator ALLARD. I think that helps add credibility, and I just ask that question in a positive vein, by the way.

And, also, Mr. Chairman, that concludes my questions, I'd just ask that my introductory remarks be made part of the record.

Senator DURBIN. Without objection.

[The statement follows:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Durbin and Ranking Member Brownback for holding today's hearing to review the fiscal year 2008 budget request for the Office of Management and Budget (OMB). This is a very important agency, and I appreciate having the opportunity to review the agency's budget.

OMB's primary role is to prepare the federal budget and to supervise its administration in Executive Branch agencies. So although the size of their actual budget might be somewhat small in Washington terms, the agency has enormous power and influence. This has been especially true over recent decades as OMB has taken a much stronger role in policy coordination.

The federal government has thousands of programs designed to meet various needs. Yet, while the needs in this country might be virtually limitless, the resources to meet those needs aren't. We can never forget that each dollar we spend as a federal government is a dollar that was taken from a taxpayer in this country. Accordingly, we must exercise great care in choosing how to invest those dollars. I say "invest" rather than "spend" quite deliberately. To spend simply indicates an outflow of resources. By contrast, to invest indicates that the outflow was made strategically with the expectation of a return on the investment.

To help make determinations between the many competing priorities, OMB has devised the PART assessment, which is a result of the Government Performance and Results Act (GPRA). The PART assessment holds agencies accountable for devising meaningful, outcome based measures for their programs. Programs that provide a good investment for taxpayer dollars should see that reflected in their budget, whereas inefficient programs should also see the status reflected in their budget.

I have been a bit puzzled recently by those who are increasingly resistant to the PART program. As I said earlier, given that taxpayer dollars are much more limited than needs, we must view allocations as investments. Would those same critics invest in a stock, bond, mutual fund, hedge fund, or other investment vehicle without ever asking about the return it has produced? Of course not. It would be irresponsible for us to not ask similar questions of federal programs.

I am pleased that we have Director Portman here with us today. I always enjoy hearing from him as part of the Budget Committee, but I look forward to this opportunity to delve more into the workings of OMB as an agency.

Director Portman, I know you have a very busy schedule, so I sincerely appreciate your time today, and I look forward to your testimony.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. I'd like to say that there are other questions for the record that will be submitted for your consideration, I hope you can provide us with prompt responses. The hearing record will remain open for a period of 1 week until Wednesday, April 18 at noon for subcommittee members to submit statements and/or questions for the record.

[The following questions were not asked at the hearing, but were submitted to the Office for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

COMPETITIVE SOURCING: INHERENTLY GOVERNMENTAL VS. COMMERCIAL ACTIVITIES

Question. Circular A–76 states that agency personnel shall use the circular's definition of "inherently governmental" in preparing their justifications. Is any other guidance provided to agencies as to what type and scope of information constitutes sufficient justification?

Answer. Since the Circular was revised in May 2003, OMB has not issued additional guidance regarding the development of justifications to explain the inherently governmental nature of an activity. We expect justifications to include sufficient information about the function performed to enable a reasonable person to understand why the function was categorized as inherently governmental.

Question. What happens if OMB does not agree with an agency's justifications for inherently governmental activities? Who has final authority over the agency's list of inherently governmental activities and accompanying justification?

Answer. Pursuant to the requirements of the Federal Activities Inventory Reform Act, OMB reviews agency inventories prior to their publication. OMB may offer comments on the inventory during the consultation process, but does not make final determinations on whether specific agency positions are inherently governmental or commercial. All final determinations regarding the classification of activities are made by the agency.

Question. Have consultations between OMB and agencies ever resulted in shifting activities from an inherently governmental list to a commercial inventory or vice versa? How many functions and FTEs have been shifted, for each agency and each year, from one list to another? What has been the net result government-wide?

Answer. Over the years, there has been some shifting between the inherently governmental and commercial lists as agencies gain a clearer understanding of their activities and make incremental improvements to more clearly and accurately identify the functions performed by their workforce. In 2005, 43.1 percent of activities were identified as inherently governmental and 57.9 percent of activities were identified as commercial. In 2004, the figures were nearly identical—i.e., 42.5 percent inherently governmental and 57.5 percent commercial. We expect the same general figures for 2006.

Since 2003, there has been a slight shift in overall figures with an increase in commercial activities. However, this shift has had only a negligible impact in terms of work being shifted from agency to contract performance. After revisions were made to Circular A–76 in 2003, no work has been converted from public to private sector performance unless a public-private competition was conducted, and competitions have been applied only to a small fraction of the entire workforce—less than 3 percent of all activities since fiscal year 2003. Moreover, Federal employees have won 83 percent of all competitions conducted during this time period.

Equally important, agencies have carefully tailored their use of competition to highly commercial support activities that the private sector is well equipped to perform. According to agencies' 2005 inventories, a substantial number of commercial activities (more than 40 percent of all commercial activities) are excluded from consideration for competition. These exclusions are largely based on a need to preserve in-house core capabilities. Some commercial positions are excluded from consideration for competition for other business reasons (e.g., private sector interest unlikely).

Question. Currently, OMB devises for agencies competitive sourcing plans that cover three out-years. It is my understanding that OMB has now determined to devise competitive sourcing plans that cover eight out-years.

Is this true? If so, why is a longer period necessary? What would this mean practically for agencies? Would agencies, for example, be required to review for privatization additional employees? What does this mean for the current "green" plans? Will they all have to be revised?

Answer. Agencies—not OMB—develop competitive sourcing plans that are tailored to the mission and workforce needs of their agencies. OMB has not asked agencies to develop new plans or significantly modify their existing plans. However, since 2003, when OMB first developed guidance on "green" competition plans, we have asked agencies to continually update plans based on changed conditions, improved insight into their programs, and results achieved in conducting competitions. This approach has helped agencies focus their attention where competition makes the best sense. As a result, projected savings are significant despite the small percentage of the workforce competed. In fiscal year 2006, for example, agencies competed only 0.4 percent of the workforce. Yet these competitions are expected to generate savings of $1.3 billion for taxpayers over the next 5–10 years.

STAFFING

Question. How is your staff allocated among the various offices and organizational units within the agency? How many are in each?

Answer.

EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET—PERSONNEL SUMMARY

[Distribution by Program Activity for Full-time Equivalent Positions]

Program Activity Structure	Fiscal year 2006 FTE actual	Fiscal year 2007 FTE estimate	Fiscal year 2008 FTE estimate	Fiscal year 2007 to fiscal year 2008 difference
National Security Programs	62	65	65	.....
General Government Programs	51	64	64	.....
Natural Resource Programs	57	61	61	.....
Human Resource Programs	66	67	67	.....
Office of Federal Financial Management	17	18	18	.....
Information and Regulatory Affairs	50	50	50	.....
Office of Federal Procurement Policy	11	14	14	.....
OMB-wide Offices	152	150	150	.....
Total Direct Program	466	489	489	.....

Question. What is the percentage of OMB employees who will be eligible for retirement over the next five years?

Answer. As of 2012, 21 percent of OMB's current employees will be eligible for retirement.

ENTERPRISE SERVICES INITIATIVE

Question. Within the Executive Office of the President (EOP), there is an initiative known as the Enterprise Services Initiative. This involves EOP agencies, including yours, transferring their space rental costs and some other costs to the Office of Administration to be paid by that office.

Why is this a good idea?

Answer. The intent of the Enterprise Services Initiative is to gain administrative efficiencies by having only one single manager and payer for common services that cut across the EOP, thereby making more efficient use of the OA financial staff, component financial managers, and representatives from supporting servicing agencies. Specifically, the net result will consolidate over 28 relatively small service agreement accounts into six service agreement accounts with a corresponding significant reduction in the processing of over 180 payment transactions between multiple staffs. Further, agencies outside the Executive Office of the President will have a single point of contact in coordinating and negotiating service agreements vice having to work individually with each of the separate EOP components included in the fiscal year 2008 Enterprise Services Initiative.

Question. What are the benefits?

Answer. Specifically regarding the consolidation of space rent, most EOP components have already successfully consolidated space rent costs in the OA appropriation. Completing this consolidation initiative for OMB and ONDCP will provide consistency in managing rent across the EOP while facilitating the oversight of office space allocation. Currently, managing space rent allocation and corresponding rent costs between OA, ONDCP and OMB is complex, especially in light of the ongoing EEOB modernization program entailing frequent office moves within the EOP complex. (Note: OMB rent was included in the Enterprise Services initiative in fiscal year 2005 but was subsequently returned to OMB's appropriation in fiscal year 2006.)

Question. How much of your budget would be transferred to the Office of Administration?

Answer. OMB's fiscal year 2008 budget request proposes to move $7.903 million to the Office of Administration as part of the Enterprise Services Initiative.

Question. The Office of Administration budget includes about $12 million for a Capital Investment Plan. Does OMB benefit from those funds?

Answer. Yes, OMB benefits. The Capital Investment Plan is used for system lifecycle replacements for OMB's desktop computers, printers, and laptop replace-

ments. Additionally, these funds support the Executive Office of the President's network infrastructure upgrades. This includes e-mail upgrades, HSPD–12 implementation, network and server regular upgrades, network storage upgrades, enterprise software licenses, and server "virtualization." These are improvements made to the systems supporting the entire EOP, as such OMB is a beneficiary.

Question. Do you receive funds from that source for IT projects?

Answer. No, the Office of Management and Budget does not receive funds from the Office of Administration's Capital Investment Plan.

PRIVACY AND CIVIL LIBERTIES OVERSIGHT BOARD

Question. The Privacy and Civil Liberties Oversight Board was established by the Intelligence Reform and Terrorism Prevention Act of 2004. It consists of five members appointed by and serving at the pleasure of the President. The Board advises the President and other senior executive branch officials to ensure that concerns with respect to privacy and civil liberties are appropriately considered in the implementation of all laws, regulations, and executive branch policies related to efforts to protect the Nation against terrorism. This includes advising on whether adequate guidelines, supervision, and oversight exist to protect these important legal rights of all Americans.

What is the current 2007 budget for the Privacy Board and what is the request for 2008?

Answer. For fiscal year 2007, the Privacy and Civil Liberties Oversight Board (PCLOB) budget is $1.5 million. As for fiscal year 2008, funding for PCLOB is funded within the White House Office program as are other offices within this program.

Question. In which account in the Executive Office of the President is the Board funded?

Answer. The Privacy and Civil Liberties Oversight Board is funded within the White House Office program.

Question. Why shouldn't this Board be funded through its own account?

Answer. The Privacy and Civil Liberties Oversight Board operates similarly to other offices within the White House Office program where staff and supporting infrastructures are routinely shared and networked within the White House as they provide direct support to the office of the President. Accordingly, it would be impractical and add additional administrative costs to segregate and track responsibilities between the Board and other offices operating within the White House Office program.

Question. How many staff members does the Board have?

Answer. The 5 member, part-time board, as appointed by the President, is in place with the exception of one member who recently resigned. Additionally, there are 3 staff members supporting the Board.

Question. Many civil libertarians and others believe that this Board lacks the independence it needs to do its job and believe that it should be removed from the Executive Branch and be independent.

What are the Administration's views on this?

Answer. As the Administration has recently explained in its Statement of Administration Policy (SAP) on S. 4, Improving America's Security Act of 2007, "The Board's present structure is in full accord with not only the spirit but also the letter of the 9/11 Commission's recommendation." In addition, the SAP explained that the Board "has integrated itself into the Administration's policy formulation and implementation processes and has moved to integrate its operations with those of the many other privacy and civil liberties offices that exist within the Executive Branch." Therefore, the Administration "supports the work and structure of the existing Privacy and Civil Liberties Oversight Board." To change the structure of the Board, as S. 4 proposed to do, "would thrust unwarranted disruption onto a structure that is operating effectively to fulfill its statutory mission."

In addition, the Board recently issued its first annual report to Congress in which it detailed its stand-up activities and advisory and oversight initiatives. The report further outlines the Board's plans for the year ahead and demonstrates its commitment to fulfilling its statutory responsibilities. As explained in the report, "By empowering the Board with broad access to records, the Intelligence Reform and Terrorism Prevention Act of 2004 has created a Board that can offer a distinctly independent perspective to the President, along with oversight of executive agencies."

PROGRAM ASSESSMENT RATING TOOL (PART)

Question. Can you tell the Committee how you can ensure the objectivity of PART so that it is not influenced by political considerations?

Answer. The Program Assessment Rating Tool (PART) is designed to provide credible, objective assessments of program performance to inform resource decisions and actions to improve program effectiveness. The PART asks basic questions about program design, management, and execution and requires evidence to document affirmative answers. The explanation for each question and the supporting evidence are made available to the public at www.ExpectMore.gov, making them subject to public scrutiny. The PART is a comprehensive assessment of a program that draws from available data; reports from the Government Accountability Office and Inspectors General are common sources of evidence for PART answers.

In addition, the process for completing the PART—a collaborative one where agency and OMB staffs cooperate to review the program—also helps ensure the assessment is fair. A key aspect of this collaboration is identifying appropriate performance measures for the program that focus on the outcomes that are important to the American people. Each year there is a centralized review of all PARTs to ensure they are being completed consistent with the guidance and to review the quality of performance measures. Finally, agencies have the opportunity to appeal any disagreements to high level interagency panel of deputy secretaries.

While these controls are meant to ensure PART questions are answered objectively, users of the instrument can and should make their own judgments by assessing the evidence on which answers to PART questions are based, all of which is available at www.ExpectMore.gov.

Question. If a program has a low PART score, does that automatically mean that its budget will be cut?

Answer. Program performance, as assessed with the PART, is an important factor in budget decisions, but it is not the only factor. We should work to invest taxpayers' dollars into programs that produce the greatest results, but we also need to meet all the nation's priorities, including improving the performance of key programs. A good PART rating does not guarantee a specific level of funding. A program may be effective, but if it has completed its mission, if it is unnecessarily duplicative of other programs, or if there are higher priorities, its funding may be reduced. Likewise, an Ineffective or Results Not Demonstrated (RND) rating does not guarantee decreased funding. An program rated Results Not Demonstrated may receive additional funding to address its deficiencies and improve its performance.

PART is a factor, though rarely the only factor, in determining a program's funding.

Question. How is a program's PART score determined? What is the process?

Answer. With the PART assessment, agencies and OMB answer approximately 25 common-sense questions about each program's performance and management. These include:

—Is the program's purpose clear and is it well designed to achieve its objectives?

—Does the program have clear, outcome-oriented goals?

—Is the program well managed?

—Does the program achieve its goals?

The answers to specific questions in the PART translate into section scores which are weighted to generate an overall score. Because reporting a single weighted numerical rating could suggest false precision, or draw attention away from the very areas most in need of improvement, numerical scores are combined and translated into qualitative ratings: Effective, Moderately Effective, Adequate and Ineffective. Regardless of overall score, programs that do not have acceptable performance measures or have not yet collected performance data generally receive a rating of "Results Not Demonstrated."

The Results Not Demonstrated rating suggests that not enough information and data are available to make an informed determination about whether a program is achieving results. On the other hand, a program earns an Ineffective rating when there is clear evidence that is not achieving its intended outcomes. For instance, there may be data showing the program has failed to meet its goals and has external evaluations documenting its ineffectiveness.

Ineffective programs have been unable to achieve results due to a lack of clarity regarding the program's purpose or goals, poor management, or some other significant weakness.

Once each assessment is completed, the agency and OMB develop a program improvement plan so we can follow up and improve the program's performance.

Assessing and improving how programs are working is a key part of OMB's statutory mission. Our conclusions about program performance and management are based on the Program Assessment Rating Tool (PART), a diagnostic tool that helps us make budget decisions, but also drive program improvements.

Question. GAO has recommended extending the Program Assessment Rating Tool to tax expenditures, many of which are just programs run through the tax side.

What are your plans for moving forward to develop a framework and set a schedule for conducting performance reviews of tax expenditures?

Answer. The PART has been used to assess tax expenditures, like the New Market Tax Credit and the Earned Income Tax Credit. Although there are no plans to examine tax expenditures with the PART this year, we will look for opportunities to apply this assessment to other tax expenditures in the future.

Question. I would ask that for the record you provide examples of programs in the fiscal year 2008 budget that: (1) received additional funding due to strong PART scores; (2) received additional funding to correct deficiencies, as measured by PART; and (3) received less funding due to poor PART scores.

Answer. While PART and other performance information are an important factor in developing the President's Budget, these proposals are not based just on the overall PART rating. Instead, resource allocations consider specific aspects of program performance that suggest how taxpayer dollars could be most effectively invested.

Refugee Transitional and Medical Services (rated Effective) in the Department of Health and Human Services is recommended for additional funding in the fiscal year 2008 President's Budget for additional caseload support. A PART review conducted by HHS and OMB found that the program is focused on achieving meaningful performance outcome goals, works well with its partners, including State Refugee Coordinators, voluntary agencies, and ethnic organization partners; and has demonstrated improved efficiencies since fiscal year 2000. In addition, the program is working with grantees to improve data collection and monitoring.

The fiscal year 2008 President's Budget recommends an increase in funding for the National Parks Service Facility Maintenance (rated Adequate) so that it can continue improvement the quality of park facilities. The condition of park facilities has not been at acceptable levels, but the Parks Service now has a comprehensive inventory and is working systematically to improve its facilities and monitor results using a Facility Condition Index.

The fiscal year 2008 President's Budget proposes to eliminate the Supplemental Education Opportunity Grants (rated Results Not Demonstrated) in the Department of Education. Program funds are distributed using a formula that benefits more established institutions and results in proportionally less funding going to institutions that educate the largest proportion of low income students. In addition, a higher proportion of program funds support administrative costs, as compared to Pell Grants. The savings from this termination and other student aid reforms are directed to better-targeted programs, such as Pell Grants.

E-GOVERNMENT INITIATIVE

Question. For the past several years, you have had an initiative that you call e-government, or "egov". This is an attempt to make government more efficient through the increased use of information technology to perform some of the basic functions of government.

Can you give us a status report on the e-gov initiative? How much progress has been made?

Answer. Marking the 4th anniversary of the E-Government Act of 2002, OMB recently released a report highlighting the progress and future goals of the Administration to make government more effective and citizen-centered through improved utilization and management of information technology. The report identifies the successes and aggressive goals set by agencies under the President's Management Agenda (PMA) E-Government Initiative to improve information resources management, enhance customer service, and for the first time, measure the impact, utilization, and effectiveness of programs on the users of these services.

Also, in February 2007, OMB submitted to Congress the second annual "Report to Congress on the Benefits of the E-Government Initiatives". The report outlines the purpose of the E-Government and Line of Business Initiatives and highlights the benefits agencies receive from the initiatives to which they provide funding contributions. The report is available at www.egov.gov.

Five years ago, OMB and agencies launched the Presidential E-Gov Initiatives for improved government services. Operated and supported by agencies, these Presidential initiatives are providing high-quality and well-managed solutions throughout the Federal government. In 2005, the Lines of Business (LoB) task forces were initiated with the intention of identifying common solutions and methodologies to increase operational efficiencies, improve services and decrease duplication. During fiscal year 2006, agencies successfully completed major development milestones and are showing greater adoption and use of these services from citizens, businesses and government agencies.

In the past few years, we have worked with agency managing partners of the E-Gov initiatives to specifically identify clear and measurable goals to achieve the maximum use and benefit. The metrics with descriptions and type to address adoption/participation, customer satisfaction and usage are now available on our website, http://www.egov.gov.

Highlights include:

—*Government to Citizen Portfolio*.—To date, GovBenefits.gov receives more than 301,875 visits per month by citizens and provides more than 118,579 referrals per month to agency benefits programs. In the 2006 tax filing season, over 3.9 million citizens filed taxes online for free using IRS Free File.

—*Government to Business Portfolio*.—As of August 2006, the Expanding Electronic Tax Products for Businesses initiative made electronic forms available for business to electronically file Employment Taxes, Corporate Income Taxes, Employer Identification Number and Wage Reporting, with these 9 percent of corporate income tax forms were filed electronically.

—*Government to Government Portfolio*.—Since 2006, all 26 grants making agencies use Grants.gov to post the over 1,000 grant programs they make, with an overall customer satisfaction of 56 percent.

—*Internal Efficiency and Effective (IEE) Portfolio*.—Federal job seekers have continued to use USAJobs.gov to look for employment opportunities and create résumés online, with an overall customer satisfaction of 77 percent.

—*Lines of Business (LoB) Efforts*.—Federal agencies continue to work on implementations in the areas of Financial Management and Human Resources. The other LoBs; Health, Case Management, Grants Management, Cyber Security, Infrastructure, Budget Formulation and Execution and Geospatial, continue to facilitate collaboration amongst agencies.

Question. What are the main functions of government that lend themselves to an e-gov approach?

Answer. E-Government uses policy and technology to ensure security and privacy of data within the Federal government while working to improve government efficiency and effectiveness supporting the delivery of citizen-centric services. With the increasing use of technology throughout all aspects of the public and private sectors, the "E-Gov approach" is applicable government-wide. For example:

—*Grant Management*.—There are many agencies in the government that perform this functionality. Working as a group the grant making agencies can save money by investing in technology solutions together and foster interoperability by using joint standards.

—*Geospatial*.—There are many emerging technologies in this area. Agencies can work together to evaluate and select technologies that are best suited for the federal government, rather than independently doing evaluations duplicating the process and cost to the federal government.

Question. What is OMB's role in the e-government initiative?

Answer. OMB works with agencies and the CIO Council to establish strategic direction and performs ongoing oversight to assist agencies in achieving results through government-wide solutions including the E-Gov initiatives and the Federal Enterprise Architecture (FEA). This oversight includes ensuring the E-Government initiatives follow their agencies' capital planning and investment control (CPIC) processes and adhere to all applicable policies and law, including privacy, security, and earned value management. Also, OMB has provided leadership in the area of governance processes to assist agencies in working collaboratively.

Question. How much money is budgeted for e-gov initiatives in fiscal year 2008?

Answer. In fiscal year 2008, agencies will contribute $150 million towards E-Gov initiatives.

Question. Do you have any new e-gov initiatives planned for the coming year?

Answer. Currently, there are no new E-Gov initiatives planned, however, as an opportunity/need arises we will certainly consider the addition.

INFORMATION TECHNOLOGY

Question. The Management Watch List and the High Risk List are tools used by OMB to help agency officials monitor agency Information Technology (IT) planning, as well as improve project performance. These lists are updated quarterly to ensure that agencies are effectively managing their IT investments and improving the ability of the Federal government to deliver information and services to the public.

First, tell us specifically what the Management Watch List is and how it is used.

Answer. The President's fiscal year 2008 budget reported 263 major investments representing about $10 billion on the "Management Watch List." Investments on the "Management Watch List" need overall improvement in capital planning and invest-

ment activities—including, but not limited to: performance measurement, earned value management or system security. Before the start of the fiscal year, agencies were directed to remediate the shortfalls identified prior to expending additional funds. The agencies work to remediate the weaknesses and monitor the progress of the IT investment. If an investment is still on the "Management Watch List," agencies must describe their plans to manage or mitigate risk before undertaking or continuing activities related to that investment, and the investment is placed on the High Risk list.

Question. How does it differ from the High Risk List?

Answer. The Management Watch List (MWL) is based on planning documentation presented in the exhibit 300 (or "business case"). The High Risk List is based on agency execution of IT projects. The Management Watch List is for the upcoming fiscal year while the High Risk is based on the current fiscal year. Therefore, items on the High Risk List are not necessarily based on past performance—rather, they are projects requiring additional monitoring due to the size and complexity of the project, or the nature of the risk for the project. Conversely, items on the Management Watch List appear to require additional planning and/or implementation of controls based on documentation available. Finally, the Management Watch List is based on IT investments while the High Risk List is based on IT projects.

Question. What are the criteria that are used to decide whether to put an IT project on one of these lists?

Answer. Investments are placed on the Management Watch List if their investment justification needs improvement in various stages of the capital planning and investment control process, including, but not limited to areas such as: project management, performance measurement, earned value management or system security.

A project is placed on the high risk if it meets the following criteria per OMB memo, M05–03, "Improving Information Technology (IT) Project Planning and Execution," http://www.whitehouse.gov/omb/memoranda/fy2005/m05-23.pdf. High risk projects as defined in OMB Circular A–11 include those requiring special attention from oversight authorities and the highest levels of agency management because—

—the agency has not consistently demonstrated the ability to manage complex projects;

—of the exceptionally high development, operating, or maintenance costs, either in absolute terms or as a percentage of the agency's total IT portfolio;

—it is being undertaken to correct recognized deficiencies in the adequate performance of an essential mission program or function of the agency, a component of the agency, or another organization; or

—delay or failure would introduce for the first time unacceptable or inadequate performance or failure of an essential mission function of the agency, a component of the agency, or another organization."

Question. Is the number of projects on these lists increasing each year?

Answer. The number of projects for the High Risk List and the number of investments on the Management Watch List are dynamic.

The High Risk List OMB published in April 2007, includes 549 projects determined to be high risk due to different factors, such as the complexity, risk, or the level of importance. The President's budget reported in February identified 477 projects on the High Risk List. The increase on the High Risk List is attributable to increased management oversight reported by agencies.

The number of investments on the Management Watch List varies. While an investment might be initially placed on the Management Watch List, agencies have an opportunity to remediate these planning documents prior to the fiscal year. When the President released his fiscal year 2007 budget, there were 263 investments initially placed on the Management Watch List; however, by the end of the fiscal year 2006 there were just 84. When the President released his fiscal year 2008 budget there were 346 investments placed on the Management Watch List. However, agencies are able to continue to remediate these deficiencies and as of March 31, 2007, there are 183 investments on the Management Watch List. OMB continues to work with agencies to remediate the deficiencies in the remaining investments.

Question. Does OMB have the resources to adequately follow up on the Management Watch List projects? If not, what plans, if any, do you have to seek assistance from others (e.g. IG offices and other oversight bodies) in tracking the resolution of projects with weak business cases?

Answer. Yes, OMB has the resources to adequately follow up on the investments on the Management Watch List. Additionally, OMB works with the President's Council on Integrity and Efficiency (PCIE), as well as agency Inspector Generals (IGs), to assist with independent verification and validation for areas of concern.

OMB also works in partnership with agencies and GAO to address deficiencies in several high-risk programs.

The so-called exhibit 300s are essentially business cases that OMB requires agencies to develop to justify funding requests for their major IT projects.

Question. In a review conducted about a year ago, GAO found that agencies' exhibit 300s were not always reliable or accurate. What actions have OMB and agencies taken since that time to address this issue?

Answer. OMB and agencies took a number of actions to address this issue. OMB made significant changes to both the guidance and the actual exhibits 53 and 300 for agencies' fiscal year 2008 IT Budget request. The changes were intended to improve the quality and accuracy of the data. OMB met with agencies to discuss the changes to the exhibits and answer questions from the agencies. As part of this year's budget review, OMB also increased its requests for the underlying documentation referenced in the exhibit 300. At OMB's request, the PCIE and Executive Council on Integrity & Efficiency (ECIE) also conducted an assessment to ascertain the reliability of agencies' Exhibit 300s. This review was completed in March, 2007. OMB will continue to work with the PCIE and ECIE on areas identified for improvement. Finally, OMB continues to work with the agencies and the CIO Council to help improve agency employee understanding of their IRM responsibilities including the planning for information technology projects.

REGULATORY POLICY

Question. On January 18, President Bush issued amendments to Executive Order 12866, which further centralize regulatory power in the Office of Information and Regulatory Affairs (OIRA) in OMB and shift it away from the federal agencies given this power by legislative enactments.

Three aspects of the amendments seem troubling: (1) the identification of "market failure" as the first principle in promulgating regulations, (2) the designation of a presidential appointee as the Regulatory Policy Officer in each agency covered by the Executive Order, and (3) the requirement that significant guidance documents undergo nearly the same OIRA review process required of significant regulations.

Why were these changes made in the Executive Order?

Answer. The primary purpose for the issuance of Executive Order (EO) 13422 was to amend EO 12866 in order to establish an interagency review process for significant guidance documents, which would serve as a complement to OMB's issuance of the Final Bulletin on Agency Good Guidance Practices (the Bulletin). The Bulletin and EO 13422 are aimed at ensuring that significant agency guidance documents are developed through procedures that ensure quality, transparency, public participation, coordination, and accountability. As EO 12866 was being amended to establish the interagency review process for significant guidance documents, this provided an opportunity to make additional (non-guidance) amendments to EO 12866 that reflect good-government practices.

The review process for guidance documents is quite different from that of regulations. First, pursuant to EO 12866, OIRA reviews an agency's significant regulations. Pursuant to EO 12866, as amended, however, agencies will provide advance notice of significant guidance documents to OIRA and OIRA will notify the agency if additional consultation will be necessary before the issuance of the significant guidance document; OIRA will not review all significant guidance documents. Second, under EO 12866, an agency must prepare a formal cost-benefit analysis for an economically significant regulation. By contrast, under EO 12866, as amended, while agencies must make basic estimates to determine if a guidance document is economically significant, there is no requirement for the agency to prepare a formal cost-benefit analysis. Accordingly, guidance documents will not undergo the same review process as do regulations.

EO 12866, as amended, provides that agencies must identify in writing the specific market failure or other specific problem that they intend to address. As an initial matter, the reference to market failure is not a new concept; it was referenced in the "Statement of Regulatory Philosophy and Principles" in the first section of EO 12866 as it was issued by President Clinton in 1993. It was also discussed extensively in other OMB documents issued under President Clinton (in then-OIRA Administrator Katzen's 1996 "Memorandum re: Economic Analysis of Federal Regulations Under Executive Order No. 12866") and President Bush (in the 2003 proposed and final versions of OMB Circular A–4 for Regulatory Analysis). EO12866, as amended, includes reference to the classic examples of market failure including externality (environmental problems being the classic example), market power, and inadequate or asymmetric information. Second, EO 12866, as amended, does not make the identification of a market failure the only basis on which a Federal agency

can justify regulatory action. The revised section also encourages agencies to identify any "other significant problem that it intends to address." Finally, this revision does not impose a new requirement on rulemaking agencies as agencies should already have been identifying in writing the precise nature of the problem that the agency is seeking to remedy through regulatory action to demonstrate to the public, Congress, and the courts that the agency has exercised its regulatory authority in a reasonable and well-considered manner.

EO 12866, as amended, provides that each agency head shall designate one of the agency's Presidential Appointees to be its Regulatory Policy Officer and advise OMB of such designation. However, many of the Regulatory Policy Officers had already been Presidential appointees (and most of these Presidential appointees held Senate-confirmed positions) prior to the issuance of EO 13422. The chief advantage of having a Presidential appointee serve as the Regulatory Policy Officer is that it ensures accountability with respect to this role.

Question. Have you estimated the number of guidance documents OMB will be expected to review in fiscal year 2008?

Answer. Under EO 12866, as amended, after agencies provide advance notice of significant guidance documents to OIRA, OIRA will notify the agency if additional consultation will be necessary before the issuance of the significant guidance document. As EO 13422 was issued in January of 2007, OMB does not yet have much experience in its implementation, and OMB has not determined how many significant guidance documents it will review in fiscal year 2008. The number of significant guidance documents selected by OIRA for additional consultation will likely vary from year to year, depending on a variety of factors, one of them being the types and number of significant guidance documents that agencies develop from one year to the next.

Question. How many additional staff, with what sets of skills, will be needed to accomplish these reviews? Were the revised regulatory review requirements considered in formulation of OMB's budget request for fiscal year 2008? If not, why not?

Answer. It is not expected that additional staff will be necessary as it is OMB's plan to utilize OIRA s existing staff in the implementation of EO 12866, as amended, and the Bulletin. OIRA staff currently review draft rules pursuant to EO 12866, draft information collections pursuant to the Paperwork Reduction Act, and some drafts of guidance documents. These same staff will review significant guidance documents selected for review by OIRA pursuant to EO 12866, as amended. The submitted budget request documents do not contain requests for additional funding because it is expected that EO 12866, as amended, and the Bulletin can be implemented with existing resources.

OUTSOURCING—"COMPETITIVE SOURCING" OMB CIRCULAR A–76

Question. Recently, OMB Associate Administrator Matthew Blum was reported to have said that the Administration would soon publish new guidance relating to the public-private competitions that federal agencies conduct. (Government Executive article, dated 4/4/07)

Can you tell me more about what you will be proposing and why?

Answer. On April 13, 2007, OMB issued a memorandum to the President's Management Council providing guidance to help agencies substantiate that savings are achieved and performance is improved through public-private competition. The guidance includes a requirement for all PMA agencies to develop plans for the independent validation of a reasonable sampling of competitions. The guidance is available at http://www.whitehouse.gov/omb/procurement/comp__src/cs__validating__results.pdf.

Question. Do you expect this guidance to result in more federal employee jobs being privatized?

Answer. No. The purpose of the guidance is to ensure agencies and taxpayers receive the expected benefits from competition. OMB hopes these efforts will further strengthen accountability for results—irrespective of who the selected provider is—and reinforce public trust and confidence in the competitive sourcing initiative.

Question. Currently, federal employees do not have the same rights that contractors possess to appeal contracting-out decisions to GAO and the Court of Federal Appeals. A senior procurement official whose job is not among those being considered for contracting-out can appeal on behalf of affected employees in very narrow circumstances. In order for there to be any confidence in the integrity of the "competitive sourcing" process, it is understood that both sides should have the same appeal rights.

What approach would the Administration prefer the Congress to take to rectify this imbalance: giving appeal rights to federal employees actually being reviewed for

privatization or taking away appeal rights from contractors, so that there can be a level playing field?

Answer. OMB believes protest rights are more balanced than described above. For example, contractor employees, like federal employees, do not have an independent right to protest to the GAO. Although the law limits the representative for agency protests to the agency tender official (ATO), the law also requires the ATO to notify Congress whenever the ATO fails to pursue a protest to the GAO on grounds requested by a majority of the employees engaged in the performance of the competed function. There is no similar reporting requirement for companies that do not pursue protests requested by their employees.

ARE POLITICAL ACTIVITIES BEING ENCOURAGED AT FEDERAL AGENCIES?

Question. Recent reports have discussed potential improprieties by the GSA Administrator and the activities of the top aide to political advisor Karl Rove. That aide and the GSA Administrator apparently met with GSA political appointees about the 2006 election results and Republican goals for 2008.

To what extent are the White House and OMB engaged with the political appointees at federal agencies about election outcomes?

Answer. OMB regularly circulates Hatch Act guidance to its employees. First, OMB includes Hatch Act information in its annual mandatory ethics training for employees. OMB senior staff receive live ethics training each year, in compliance with Office of Government Ethics regulations; other OMB staff receive live ethics training every third year and paper ethics training in the ensuing years. All training sessions, whether live or paper, include Hatch Act guidance. Secondly, OMB circulates specific Hatch Act guidance to all employees every two years, which coincides with the federal election cycle. OMB last circulated its specific Hatch Act guidance on September 25, 2006.

PRIVACY AND SECURITY OF PERSONAL INFORMATION ROLE OF OMB IN GOVERNMENT COMPUTER DATA BREACHES

Question. Personal data security breaches are being reported with increasing regularity. These breaches occur not only because of illegal or fraudulent attacks by computer hackers, but often because of careless business practices, such as lost or stolen laptop computers, or the inadvertent posting of personal data on public websites.

Federal agencies are not immune from this unsettling problem. In May 2006, 26.5 million veterans and their spouses were in danger of identity theft because a Veterans Affairs data analyst took home a laptop computer containing personal data which was later stolen in a burglary. Other incidents of potentially compromised data in 2006 involved the Departments of Agriculture, Commerce, Defense, Energy, State, and Transportation, the Federal Trade Commission, the Internal Revenue Service, the Government Accountability Office, the National Institutes of Health, and the Department of the Navy.

Director Portman, it appears some steps have been taken to address this disturbing problem of data breaches involving personal and sensitive information in government computers, but are they the right ones?

Answer. Yes, and we are continuing our efforts in this area. As recommended by the President's Identity Theft Task Force in their interim recommendations issued by Clay Johnson on September 20, 2007 titled, "Recommendations for Identity Theft Related Data Breach Notification" (www.whitehouse.gov/omb/memoranda/fy2006/task_force_theft_memo.pdf), agencies use a risk-based approach when analyzing and responding to data breaches of sensitive information.

Question. Are we doing enough?

Answer. Although there is continued progress toward the establishment of appropriate safeguards, most Federal agencies are still at risk for improper access and disclosure of personally identifiable information and other sensitive information, as described by the IGs evaluations completed in October 2006. There is continued need for agencies to identify and properly categorize sensitive information; refine organizational policy, and implement comprehensive solutions to protect sensitive information being transported or stored offsite, or remotely accessed.

Question. Can we achieve "zero tolerance" in this arena? What tools and resources would it take?

Answer. A significant factor in data breaches is human error, which results from failure to successfully implement security and privacy policies. "Zero tolerance" would only be possible when agencies focus beyond compliance and manage the risk through the use of an integrated and comprehensive privacy and security awareness training of all personnel, responsibility-specific training when appropriate, and suc-

cessful implementation of privacy and security policies. However, we cannot guarantee these incidents will not happen, but rather the agencies will have the ability to properly respond to minimize the risk of our citizen's data.

Question. In addition to the directives on encryption, access, timely reporting, and management response issued last year, what other initiatives is OMB considering to help resolve this problem or mitigate the risk?

Answer. OMB is focused on implementing existing law and policies, and following the recommendations identified in the report submitted to the President by the Identity Theft Task Force on April 23, 2007.

Question. Are you contemplating issuing any further directives that compel agencies to enhance IT inventory controls, including the creation of comprehensive databases for all departmental property?

Answer. We rely on the information agencies provide in the annual report on security under the Federal Information Security Management Act (FISMA) and the assessment by the agencies' Inspectors General for the quality of agency system inventories. Additionally, the E-Government Act requires agencies to report on their privacy program, and agencies report to us on the number of completed privacy impact assessments (PIAs) and system of records notices (SORNs).

Question. Are there special or unique challenges that Federal departments and agencies face when it comes to tackling this problem?

Answer. The public and private sectors are faced with similar security and privacy issues, and would benefit by exchanging lessons learned and best practices. Because Federal agencies provide the public services requiring we maintain significant amounts of information concerning individuals, we have a special duty to protect that information from loss and misuse.

Question. Are the funding amounts agencies are requesting sufficient?

Answer. The budget submitted by the President requests the appropriate funding amount to address the Administration's initiatives for security and privacy.

Question. How do you know whether agencies are complying with your July directive to timely report within one hour? Are there any consequences for delays or failures to report?

Answer. We have seen an increase in the amount of reports submitted through US CERT, which would suggest increased compliance with the directive. Individual agencies are responsible for establishing consequences for failure to follow agency policies. However, it is important to recognize reporting in and of itself is not a failure, but rather, a necessary procedure to help agencies respond to incidents in a timely and effective manner, and protect citizens to the maximum extent possible when a situation does arise.

Question. Did all agencies meet the August 7, 2006 deadline for encryption requirement as directed in OMB's Memorandum issued last June? If so, how do you know? If not, why not?

Answer. Memorandum 06–16 presented four recommended actions for agencies to implement to provide better protection for information accessed remotely—one of which is to encrypt all data on mobile computers/devices which carry agency data unless the data is determined to be non-sensitive, in writing, by the agency's Deputy Secretary or designee—to be implemented through the existing framework provided within current law and policy. As of October 2006, most agencies were still in process of implementation. The public results of the Inspectors General assessment of Departments' and Agencies' status in meeting the recommendations of OMB memo 06–16, as of October 2006, are published on Internet at www.ignet.gov/pande/faec/summarypiireport.pdf. We have been working with the PCIE IT Committee to formulate an additional evaluation to measure agency progress.

Question. Should OMB play a stronger role in checking on agency compliance with your directives to date?

Answer. OMB provides the appropriate amount of oversight to the federal agencies; however, it is the responsibility of the agencies to manage the risk of their services and data in accordance with existing laws and policies.

Question. Should we heighten employee accountability standards? Is there a need to expand training?

Answer. Agencies provide employees with clearly defined policies addressing expected rules of behavior and accountability for failure to follow those rules, reinforced with training to ensure employees understand the standards and practices for which they will be held accountable. To help agencies administer effective training programs, the Information Systems Security Line of Business (ISS LoB) identified three agency training programs to serve as a common baseline for other agencies to use.

Question. Are there any legislative reforms that would be beneficial?

Answer. Legislative reform is not necessary at this time. We are focused on moving agencies towards better implementation of existing laws and policies and managing their risk levels—so that we can move "beyond compliance" to achieve improved security and privacy outcomes for our citizens to ensure trust in our services.

PRIVACY AND SECURITY FOR INFORMATION SYSTEMS: OMB DIRECTIVES ON BUDGET REQUESTS

Question. Privacy and security of data are important elements of planning, acquisition, and development of Federal information technology systems. The E-Government Act of 2002 and the Federal Information Security Management Act (FISMA) provide significant privacy and security responsibilities for federal information technology system operators.

Seven years ago, OMB issued instructions to agencies on how to integrate security into the funding for information technology ("Incorporating and Funding Security in Information Systems Investments," Memorandum M–00–07, issued 2/28/00 and incorporated in OMB Circular A–11 on budget preparation policy).

Under OMB's guidance requirements, agencies are required to: (1) Integrate security into and fund it over the lifecycle of each system undergoing development, modernization, or enhancement; and (2) Ensure that steady-state system operations meet existing security requirements before new funds are spent on system development, modernization, or enhancement.

Last July, OMB's Administrator of E-Government and Information Technology reminded agencies of the requirement to incorporate and fund security and privacy requirements within their IT investments as part of the fiscal year 2008 budget process. Agencies were specifically directed to provide additional detail on resources they devote to fixing security weaknesses. Furthermore, agencies with significant isolated or widespread weaknesses identified by the agency Inspector general or GAO were directed to identify the specific funds they were requesting to correct the security weaknesses.

Did all agencies comply with the directive on incorporating security funding in submitting their fiscal year 2008 budget requests?

Answer. Yes. All agencies submit an Exhibit 53 identifying the percentage of the agency's IT spending used for security. In addition, the Exhibit 300 submitted as part of the budget submission includes details on IT security spending.

Question. How can we be assured that all agencies across the federal government are adhering to this directive?

Answer. As part of the budget process, agency CIOs and IGs, as well as OMB, review agency Exhibit 53s and Exhibit 300's.These documents show agencies are planning for, and incorporating, security spending over the course of the investment lifecycle.

Question. What did OMB's review of the agency submissions show? Did all agencies identify the funding needs to address system security vulnerabilities as expected?

Answer. We review agency budget requests to ensure agencies identify the costs for securing their investments. When agencies submit budget requests without information about the costs for securing their investments, the Investments are placed on the Management Watch List. We also analyze agency FISMA reports and other information to help determine whether agency budget requests are justified.

Question. Can you cite some examples of budget submissions for fiscal year 2008 in which a federal agency identified specific funding requirements to address privacy and security vulnerabilities?

Answer. All agency budget submissions identify the costs for securing their investments to address privacy and security vulnerabilities.

Question. Has OMB ever substantially reduced or denied an agency's request for funding to address security weaknesses?

Answer. Agencies identify the costs for securing their investments as part of their budget request, and we use this information when determining whether agency requests are justified.

Question. Do you believe all agencies have adequate resources to address this problem of information security? Why or why not?

Answer. We believe that agencies have adequate resources to address information security. They request the funding they need in their annual budget submission, based on their assessment of security control needs and remediation of weaknesses. To determine this amount, we rely on agencies to use their plan of action and milestone process, capitol planning, and the associated information to prioritize and determine the adequate amount of resources to request in order to mitigate any weaknesses that exist.

Question. What checks are in place to assess agency systems acquisition projects to ensure that security is an integral part? Are there any consequences for non-compliance, or for proceeding to spend new funds despite not meeting existing security requirements?

Answer. The Federal Acquisition Council published a Federal Acquisition Register clause outlining the requirement for agency acquisitions to follow the requirements of federal security policies. FAR clause 52.239–1(b) includes a broad reference to programs, including security, which includes FISMA. Compliance with this clause is enforced through the FAR process. On April 25, 2007, OMB issued a memorandum regarding the Federal Acquisition Certification for Program and Project Managers. This memorandum establishes a structured development for program and project managers that will improve the partnership and collective stewardship of taxpayer dollars.

Question. What role does OMB play in reviewing IT spending plans to ensure that the security and privacy components are appropriately addressed?

Answer. Besides oversight from reviewing Exhibit 300s and Exhibit 53s, and other budget documents, OMB works with agencies throughout the year to assist in their project planning and implementation.

Question. Has OMB (or any agency head that you are aware of) ever halted a systems procurement due to the failure to include IT security funding in the project?

Answer. OMB views this activity as an internal agency procurement matter, and therefore, we would not necessarily know of any specific projects that have been halted. However, information related to procurement and security is submitted to OMB through the budget process in Exhibit 300 planning documentation, and it is considered as we review agency budget requests. It is important to also note agencies apply a methodology called "Earned Value Management" to regularly assess whether IT project implementation is on schedule, and within cost and performance expectations. When projects deviate significantly from established expectations, agencies have to determine whether the project should be halted, adjusted, and/or terminated.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. Mr. Portman, I have introduced a bill that would establish a "Commission on the Accountability and Review of Federal Agencies."—CARFA.

CARFA would: (1) evaluate executive agencies and their programs; and (2) submit to Congress a plan recommending agencies and programs that should be realigned or eliminated.

Are you supportive of this bill?

Answer. Yes. The Administration is strongly supportive of legislation that would enhance scrutiny and improve performance of programs.

Question. Do you believe that it would eliminate wasteful government spending and improve government agencies' performance?

Answer. Yes.

Question. Could you help me analyze taxpayers' savings that this legislation could realize by reducing government waste?

Answer. I cannot now give an accurate estimate of the amount of waste, fraud, and abuse that inflicts government today. The President's Council on Integrity and Efficiency reported $9 billion in potential savings that could result from recommendations Inspectors General made in fiscal year 2006. While eliminating government waste is a priority of the Administration, even more can be gained by making programs more effective and efficient. We are using the PART process to identify and pursue opportunities for agencies to get the taxpayers more for their money and eliminate unnecessary duplication of services. Based on agency and OMB assessments of program performance, we can say that proposed fiscal year 2008 spending on programs rated Ineffective or Results not Demonstrated exceeded $140 billion.

Question. What is the current level of uncredited contributions to Social Security by undocumented persons working in this country?

Answer. The Social Security Administration (SSA) does not know how much undocumented workers are contributing to Social Security. Uncredited contributions to Social Security are captured in the Earnings Suspense File. Employers report wages to SSA, and SSA uses the SSN to record the employees' earnings histories. The Earnings Suspense File captures all wage reports where SSA cannot verify the name and SSN of the worker against SSA s records. If SSA later resolves the mismatch, SSA removes the item from the suspense file and credits the wages to that person's record.

There are many reasons that a name and SSN may not match Social Security's records, including typographical errors and name changes. A mismatch may also occur is if a worker is using an SSN obtained fraudulently, and their name does not match the SSN in SSA s records.

SSA has no way of estimating the percentage of the Earnings Suspense File that represents work done by undocumented workers using fraudulent SSNs. The primary challenge in producing such an estimate is that SSA does not have a basis for estimating how many of the undocumented workers currently in the United States are paying payroll taxes.

Question. What would be the affect on Social Security if illegal aliens were to gain legal status?

Answer. The effect on the Social Security Trust Funds would depend on the number of undocumented immigrants receiving an adjustment in their status, and whether they were paying payroll taxes prior to that time. Under current law, individuals illegally present are not eligible to receive Social Security benefits. The effect on Social Security would also depend on how work completed prior to receiving legal status is treated for benefit eligibility and benefit calculation purposes.

The 2007 Social Security Trustees Report provides some illustrative figures regarding the effect of immigration on the Social Security program. The Trustees Report intermediate assumptions assume that net immigration will total 900,000 people per year. When net immigration is increased to 1.3 million a year, the long-range outlook improves. The 75-year actuarial balance as a percentage of taxable payroll would improve from -1.95 under intermediate assumptions to -1.70 under the higher immigration scenario. In general, increasing the number of net immigrants by 100,000 would increase the 75-year actuarial balance by .07 percent of taxable payroll.

Question. You express concern about the level of mandatory spending in the budget, how do you propose to reduce this?

Answer. While the near-term outlook in the President's 2008 budget of smaller deficits and a surplus starting in 2012 is encouraging, the current structure of the Federal Government's major entitlement programs will place a growing and unsustainable burden on the budget in the long-term. Currently, spending on Medicare, Medicaid, and Social Security is approximately eight percent of the Nation's GDP. With the first of the baby boom generation becoming eligible for Social Security in 2008, Social Security spending will accelerate. Three years later, the problem will become more pronounced as these individuals become eligible for Medicare, under which program costs rise even faster due to health care inflation. By 2050, spending on these three entitlement programs is projected to be more than 15 percent of GDP, or more than twice as large as spending on all other programs combined, excluding interest on the public debt.

The President's budget proposes a number of reforms in mandatory programs, particularly in Medicare, resulting in savings of $66 billion over five years and growing to $252 billion over 10 years. These proposals will not solve the Government's long-term fiscal challenges, but they are an important and meaningful step, producing a significant improvement over the long term. Under the President's budget policies, the deficit in 2050 is projected to be 4.7 percent of GDP. In contrast, if the Congress fails to adopt the President's mandatory proposals and permits current law to remain in force, the deficit in 2050 is projected to be 7.5 percent of GDP.

Question. Director Portman, in your testimony you have requested $410 million for enhanced income tax enforcement, how much increased tax revenue would this yield?

Answer. The budget proposes to improve the effectiveness of the IRS' activities with a $410 million package of new initiatives to enhance enforcement and taxpayer service and to improve the IRS' technology. Budget scoring rules do not permit CBO and OMB to "score" the estimated revenue increase from IRS enforcement efforts. The IRS collects $51 billion per year (2007 estimate) in direct enforcement revenue, and its enforcement program helps maintain the more than $2 trillion in taxes voluntarily paid each year. The budget's proposed funding levels for the IRS will help maintain the base revenue, and the proposed enforcement initiative should boost revenue further.

Based on historical realization rates, the IRS estimates there is a 4:1 return on expanded enforcement activities once new staff is fully trained. During 2008, the proposed enforcement initiatives are estimated to yield more than $300 million in new enforcement revenue, and once new staff are trained and become more experienced, the enforcement revenue impact of the work they complete each year is estimated to increase to approximately $700 million. However, this Return on Investment (ROI) estimate is likely understated because it does not reflect the indirect im-

pact enhanced enforcement has on deterring non-compliance. Research suggests this indirect impact is at least three times as large as the direct impact on revenue.

Question. Competitive sourcing is an integral part of the President's Management Agenda, as such, what is the expected benefit of this concept?

Answer. The reasoned and strategic application of competition is helping agencies achieve greater efficiencies and better performance. By making commercial services that support programs more efficient, agencies have more resources to spend directly on their missions. Competition motivates agencies to become more efficient through the development of improved performance standards, the adoption of new technologies, workforce realignments, the consolidation of operations, and lower contract support costs. Projected savings are significant for the small percentage of the workforce competed. In fiscal year 2006, for example, agencies competed only 0.4 percent of the entire civilian workforce. Yet these competitions are expected to generate savings of $1.3 billion over the next 5–10 years. Competitions completed since 2003 are expected to produce almost $7 billion in savings for taxpayers over the next 5–10 years. This means taxpayers will receive a return of about $31 for every dollar spent on competition. Annualized expected savings are around $1 billion.

Question. What is precluding the full application of competitive sourcing?

Answer. Despite impressive results, a number of legislative provisions limit agencies from taking full advantage of competition where it makes sense. Some restrictions prohibit agencies from competing certain activities or conducting competitions at certain organizations while others limit agency resources for competition or marginalize the consideration of quality, forcing agencies to choose between the government and the private sector solely based on lowest cost.

Many legislative restrictions appear to be rooted in concerns that competitive sourcing will be used to weaken the workforce. In fact, agencies have carefully tailored their use of competition and given federal employees a full and fair opportunity to demonstrate their value to the taxpayer. Federal employees have fared well, receiving 87 percent of the work competed in fiscal year 2006 and 83 percent of the work competed between fiscal years 2003–2006. OMB would welcome the opportunity to work with members of Congress to eliminate statutory restrictions so that competition may be used, where appropriate, to improve government operations and deliver the best results for the American taxpayer.

Question. How much has the deficit declined the past two years and do you expect it to decline again this year?

Answer. The size of the deficit and the debt is best assessed in relation to the economy as a whole, as measured by GDP. In his 2005 budget, the President set a goal to cut the deficit in half by 2009 from its projected peak in 2004. The President achieved his goal in 2006, three years ahead of schedule. The deficit in 2006 was 1.9 percent of GDP, or $248 billion. This was a reduction from the actual 2004 deficit of 1.7 percent of GDP, or $165 billion. The 2006 deficit was below the 40-year historical average of 2.4 percent of GDP, and was smaller than the deficit as a percent of GDP in 18 of the previous 25 years.

In the 2008 budget, we project the deficit to decline even further for 2007 to 1.8 percent of GDP, or $244 billion. OMB will update these projections in the Mid-Session Review.

Question. Would you recommend that the President veto the supplemental over the level of additional funding in the bill?

Answer. The President vetoed this bill on May 2 based on the inclusion of an artificial deadline for troop withdrawal from Iraq, and the addition of billions of dollars in unrelated spending.

Question. Last year OMB had its lowest staffing levels in over 30 years, how are you able to complete the important work you do under such tight budget constraints?

Answer. We have reduced staff levels over the past 6 years and attempted to be more productive with these lower staff levels. OMB has an extraordinarily dedicated and talented team of career professionals. OMB is consistently rated as the best or one of the best places to work in the federal government. We strive to recruit, train and retain the best staff we can at OMB. While the request for fiscal year 2008 is a disciplined budget, we believe it provides the resources necessary for OMB to maintain a staff of 489 and fully meet its mission.

QUESTIONS SUBMITTED BY SENATOR WAYNE ALLARD

Question. What are OMB's scores on the management scorecard?

Answer. OMB's current progress score for Human Capital, Competitive Sourcing, Financial Performance, and Budget and Performance Integration is green. While our

progress score for E-Gov is red, we are taking steps to improve that score. OMB is currently yellow in status on Human Capital, but red in status on Competitive Sourcing, Financial Performance, E-Gov, and Budget and Performance Integration.

All current and past scores for all agencies on the President's Management Agenda can be found at results.gov.

Question. Why hasn't OMB undergone a PART review?

Answer. Early in the development of the PART, the Administration made a decision to focus our evaluation efforts on programs that most directly impact the government's services to the American people. We excluded from the PART process policy functions (e.g., Office of the Secretary), central administrative functions that are not associated with specific programs, and programs and activities with a limited impact. The central administrative functions are evaluated using the President's Management Agenda scorecard.

OMB has not been assessed with the PART primarily because it serves in a policy role. This does not mean OMB has escaped oversight or scrutiny. In fact, OMB management has been held to the same standards as every other major agency with the President's Management Agenda Scorecard. That scorecard assesses the quality of OMB's personnel, financial, information technology, procurement, and performance management. Each quarter, OMB's progress and status on each of these initiatives is made available on Results.gov.

SUBCOMMITTEE RECESS

Senator DURBIN. Director Portman, I thank you for your testimony.

Mr. PORTMAN. Thank you, Mr. Chairman.

Senator DURBIN. This meeting of the subcommittee stands recessed.

[Whereupon, at 4:19 p.m., Wednesday, April 11, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

WEDNESDAY, MAY 2, 2007

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 5 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senator Durbin.

DISTRICT OF COLUMBIA

COURTS

STATEMENT OF ERIC T. WASHINGTON, CHIEF JUDGE, DISTRICT OF COLUMBIA COURT OF APPEALS

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. The hearing will come to order and my apologies for the delayed start.

Coincidentally this hearing was scheduled for the very moment that I was calling an amendment on the floor. The bad news is you had to wait patiently for over an hour and the good news is the amendment passed.

So, I'm happy to be with you and welcome you to the session before the Financial Services and General Government Appropriations Subcommittee.

Our focus today is on the budget request for four federally funded agencies which deliver vital services within the District of Columbia. I welcome my Senate colleagues who may join me now that the rollcall has been completed.

Appearing before the subcommittee this afternoon is an extraordinary panel of key officials, who devote their careers to fairly administering justice, protecting public safety, and improving the livelihood and potential for the citizens of our Nation's capital.

As I looked over their résumés, it's significant that collectively these leaders have delivered a century of distinguished public service and from my vantage point, appear to show no signs of fatigue or waning commitment. So, I thank you for that.

I welcome the Honorable Eric T. Washington, Chief Judge of the D.C. Court of Appeals; the Honorable Rufus G. King III, Chief Judge of the District of Columbia Superior Court; Paul Quander, Jr., Director of the Court Services and Offender Supervision Agen-

cy (CSOSA); Avis Buchanan, Director of the Public Defender Service (PDS) of the District of Columbia; and Deborah Gist, State Education Officer, who administers the Resident Tuition Assistant Grant Program for the District of Columbia government. Thank you for joining us.

I've had the privilege and pleasure of working on a host of important and successful legislative initiatives for the benefit of the District as part of my Senate responsibilities—having worn the hats of both authorizer and appropriator over the years. Today provides an opportunity to continue that work.

The combined funding request for the operations of the agencies appearing before the subcommittee today constitute $515.5 million—86 percent of the President's total request of $597.6 million in Federal payments to fund a dozen diverse programs in the District of Columbia.

Federal appropriations provide the sole financial resources for, not simply a contribution to, the operations of these four agencies. Three of the entities are wholly independent of any local control or oversight as a result of the Revitalization Act of 1997, which relieved the District of certain state level responsibilities and restructured several criminal justice functions.

So, it's prudent to assess how effectively and efficiently these particular agencies are currently utilizing and managing Federal resources as we look forward to deliberating the needs for the ensuing year.

For the District of Columbia Courts, the President's budget recommends a total of $213.9 million, a decrease of $2.9 million from last year's appropriation. The President's recommendation for court operations is $24.5 million—18 percent increase above the last fiscal year enacted level of $136.8 million. The President's proposed level of $52.5 million for capital improvements is $27.4 million below fiscal year 2007.

For CSOSA, the President requests $190.3 million. This is $10.7 million, or 6 percent, above the fiscal year 2007 enacted level of $179.6 million.

Under the full year continuing resolution, Congress approved an additional $8.9 million to forestall critical setbacks CSOSA faced if forced to operate at the fiscal year 2006 level. For the Public Defender Service, the President seeks $32.71 million to be provided as a direct appropriation. This is 5 percent above the fiscal year 2007 level.

For the District of Columbia Tuition Assistance Grant Program, the President seeks $35.1 million, an increase of $2.2 million, or 7 percent, above the fiscal year 2007 enacted level.

I look forward to discussing these budget proposals in greater detail. At this point, we will take the testimony of those witnesses who appear before us.

In the interest of providing ample opportunity to discuss your proposals with questions and answers, I hope you can limit your oral presentations to around 5 minutes. Your entire formal statement will be submitted for the record. Judge Washington, we will begin with you. Thank you for being here.

Judge WASHINGTON. Thank you, Mr. Chairman. Good afternoon.

Senator DURBIN. There's a button on your microphone. There you go.

Judge WASHINGTON. I hope that I've done this correctly.

Again, good afternoon, Mr. Chairman, thank you for this opportunity to discuss the D.C. Courts' fiscal year 2008 budget request.

As you noted, my name is Eric T. Washington and I'm here in my capacity as the Chief Judge of the District of Columbia Court of Appeals and Chair of the Joint Committee on Judicial Administration in the District of Columbia, the policy making body for the District of Columbia Courts.

With me this afternoon are Chief Judge Rufus King III of the D.C. Superior Court; Ms. Anne Wicks, our Executive Officer; and several other key members of senior staff.

INTRODUCTION

As you know, the District of Columbia has a two-tier court system comprised of the District of Columbia Court of Appeals, our court of last resort, and the Superior Court of the District of Columbia, a trial court of general jurisdiction. Administrative support functions for our courts are provided by an entity known as the court system.

The mission of the District of Columbia Courts is to protect rights and liberties, uphold and interpret the law, and resolve disputes peacefully, fairly, and efficiently in the District of Columbia.

Our successes in fulfilling this mission are attributable, in large part, to the consistent support we have received from Congress and the President. With your continued support, we are confident that we will be able to continue to achieve many of the strategic goals we have set for ourselves and for our community.

BUDGET PRIORITIES

The District of Columbia Courts serve approximately 10,000 courthouse visitors each day, process more than 150,000 cases each year, and employ a staff of 1,200, who directly serve the public, process cases and provide administrative support. The number of filings and case dispositions in both courts rank among the highest in the Nation on a per capita basis. It is for these reasons that our two priority items in this fiscal year's budget concern our workforce and our space needs. More specifically, the courts' fiscal year 2008 budget priority requests are for full funding for all currently authorized positions and funding to complete the old courthouse restoration.

Over the past several years increasing costs for healthcare, retirement benefits, and cost-of-living adjustments have outpaced appropriations, resulting in a significant funding shortfall in the courts' personal services budget. A sufficient workforce is essential for the D.C. Courts to meet our statutory obligations, fulfill our mission, and ensure that the public receives high quality justice and services from the judicial branch of Government. Because personal services costs make up 75 percent of the courts' budget, the shortfall has forced us to severely limit hiring.

Today the courts have a 13-percent nonjudicial vacancy rate, a vacancy rate that is beginning to detrimentally effect court oper-

ations. The requested $8.4 million will fully fund the positions currently authorized for the courts.

The courts continue to implement the facilities master plan, and this concerns our second priority issue, that was developed in 2002 and revised after passage of the Family Court Act. The plan covers the five buildings and 1.1 million gross square feet of space that comprise our campus in Judiciary Square; accordingly, resources for capital improvements remain critical.

As you know, the D.C. Courts are renovating the old courthouse for relocation of the D.C. Court of Appeals. The old courthouse is an historic landmark and the centerpiece of Judiciary Square. A few years ago, that old courthouse was vacant and uninhabitable by modern health and safety standards. At that time, the D.C. Courts were facing space shortages in the 1970s era Moultrie Courthouse. The facilities master plan defined how the courts could best create space to operate and serve the public efficiently. It makes clear that the restoration of the old courthouse, an historic landmark in need of preservation, is also the key to meeting the space needs of the D.C. Courts.

We are very pleased that Congress and the President have strongly supported this restoration project. From fiscal year 2005 to 2007, $99 million was appropriated for the construction contract. Construction began just over 1 year ago, in March 2006, and is scheduled to be completed in December 2008. We have provided your staff with pictures that show the progress that has been made to date.

The final phase of the funding requested in fiscal year 2008 is $30 million for costs not included in the construction contract, such as removal of hazardous materials, construction management, and contingency and management reserves.

To maximize the efficient use of the facility once it opens, the court's budget request also includes $2.6 million for furniture, equipment, and technology necessary to outfit the restored building.

THE PRESIDENT'S RECOMMENDATION

We're very pleased that the President's D.C. Court's funding recommendation for fiscal year 2008 supports these two priority budget items. The President's recommendation also finances another key capital project, electrical repairs in the Moultrie Courthouse and provides funds for emergency facility repairs. The Moultrie Courthouse is approximately 30 years old, and was not built to handle the expanded electrical load resulting from the use of computers and other modern office equipment. According to our energy consultant, the current electrical system in the Moultrie Courthouse is overburdened and poses a serious threat to the safety of workers and building occupants, and must be updated as soon as possible.

CONCLUSION

We have long enjoyed a reputation for excellence in the District of Columbia Courts. Adequate funding for our budget priorities is critical to our success. We appreciate the support this subcommittee has given us in the past and the present support for our

budget initiatives. We look forward to working with you throughout this process.

PREPARED STATEMENT

If there are any questions, we'd be happy to answer them at an appropriate time. Thank you very much, Mr. Chairman.

Senator DURBIN. Thank you, Judge Washington.

[The statement follows:]

PREPARED STATEMENT OF CHIEF JUDGE ERIC T. WASHINGTON

Mister Chairman, Senator Brownback, Subcommittee members, thank you for this opportunity to discuss the fiscal year 2008 budget request of the District of Columbia Courts. I am Eric T. Washington, and I am the Chair of the Joint Committee on Judicial Administration in the District of Columbia, the policy-making body for the District of Columbia Courts. I also serve as Chief Judge of the District of Columbia Court of Appeals.

As you may know, this jurisdiction has a two-tier court system comprised of the D.C. Court of Appeals, our court of last resort, and the Superior Court of the District of Columbia, a trial court of general jurisdiction. Administrative support functions for our Courts are provided by what is known as the Court System.

INTRODUCTION

We live in a changing environment, facing new challenges to our nation, our Nation's Capital, and our court system. Whatever challenges we face, the fair and effective administration of justice remains crucial to our way of life. The District of Columbia Courts are committed to responding to the changing needs of our society and meeting these new challenges. We have been steadfast in our mission, which is to protect rights and liberties, uphold and interpret the law, and resolve disputes peacefully, fairly and efficiently in the Nation's Capital. Through our Strategic Plan, the D.C. Courts strive to enhance the administration of justice; broaden access to justice and service to the public; promote competence, professionalism, and civility; improve court facilities and technology; and build trust and confidence in our courts. We appreciate the support of Congress and the President, which makes possible the achievement of these goals for our community.

To support our mission and goals in fiscal year 2008, the Courts budget submission requested $347,774,000 for court operations and capital improvements. Of this amount, $13,389,000 is requested for the Court of Appeals; $100,543,000 is requested for the Superior Court; $54,052,000 is requested for the Court System; and $179,790,000 is requested for capital improvements for courthouse facilities. In addition, the Courts requested $52,475,000 for the Defender Services account.

The D.C. Courts are committed to fiscal prudence and sound financial management. The fiscal year 2008 budget request represents an operating budget increase of $31.2 million and 20 full-time equivalent (FTE) positions over the fiscal year 2007 appropriation. The two highest priorities in the Courts' operating budget request are (1) $8,432,000 to fully fund all authorized positions, a special request in the budget submission and (2) $2,589,000 to furnish and equip the restored Old Courthouse. These two requests account for 35 percent of the operating budget increase.

As the Courts continue to implement the Facilities Master Plan for our five buildings and 1.1 million gross square feet of space, resources for capital improvements remain critical priorities. The fiscal year 2008 capital budget reflects an increase of $99,868,000 over the fiscal year 2007 level to complete the restoration and occupancy of the Old Courthouse, support critical space and technology needs, and to maintain the Courts' infrastructure. The Old Courthouse restoration remains the most pivotal item in the capital budget, with a request for $30 million to cover project costs not included in the general construction contract.

OPERATING BUDGET PRIORITIES

Special Request for Personal Services Funding

Over the past several years, increasing personal services costs for health benefits and cost of living adjustments have outpaced appropriations, resulting in a significant funding shortfall in the Courts' personal services budget. Like all organizations that serve the public, the greatest asset and resource of the D.C. Courts is our people. A sufficient workforce is essential for the D.C. Courts to meet statutory mandates, fulfill our mission, and ensure that the public receives high quality justice

and services from the judiciary. As personal services costs make up 75 percent of the Courts' budget, the shortfall has necessitated limited hiring. Today, the Courts have a 13 percent non-judicial vacancy rate, to the detriment of court operations. Staffing shortages have a profound negative impact on the fair and effective resolution of disputes and public safety. The Courts' budget request includes $8,432,000 to fully fund the positions currently authorized for the Courts to fulfill our mission. Unless this most critical issue facing the D.C. Courts is addressed, the Courts will be unable to fill mission-critical positions, and the quality of justice in the District of Columbia will be compromised.

Furniture and Equipment for the Old Courthouse

As discussed in detail below, the D.C. Courts are renovating the historic Old Courthouse for use by the Court of Appeals. The building not only will be restored in keeping with its historic and architectural significance, but it will also be returned to its original use as a courthouse to serve the people of the District of Columbia. Construction is scheduled to be complete at the end of 2008. To maximize the efficient use of space and technology, the Courts' budget request includes $2,589,000 for the furniture and equipment necessary to outfit the facility.

CAPITAL BUDGET PRIORITY: RESTORATION OF THE OLD COURTHOUSE

The Old Courthouse is an historic landmark that is the centerpiece of Judiciary Square. The cornerstone was laid with great fanfare in 1820, and its neoclassical design embodies the democratic ideals of Ancient Greece. Originally constructed as a courthouse and City Hall, it has served as a courthouse for most of its 187 years. A few years ago, it was uninhabitable, with worn out mechanical systems, hazardous materials, and numerous other violations of modern health and safety standards. Yet, its proud history and aesthetic beauty remained. At the same time, the D.C. Courts were facing space shortages in the 1970's Moultrie Courthouse, and new mandates for the Family Court increased our space requirements. A Facilities Master Plan was developed to determine how to provide enough space to operate and serve the public efficiently. It was clear that restoration of the Old Courthouse, badly needed for historic preservation, was also the key to meeting the space requirements of the D.C. Courts.

We are very pleased that Congress and the President have strongly supported this restoration. As you may know, Congress elected to finance the restoration in phases. From fiscal year 2005 though fiscal year 2007, Congress has provided $99 million for the construction contract. The final phase of the funding is $30 million for costs not included in the construction contract, such as removal of hazardous materials; wiring for security, technology and telecom equipment; construction management; and contingency and management reserves.

THE PRESIDENT'S RECOMMENDATION

I am very pleased that the President's recommendation for fiscal year 2008 supports our most important priority items: personal services funding and restoration of the Old Courthouse. In addition, the President's recommendation finances two key capital items: electrical repairs in the Moultrie Courthouse and emergency facility repairs. The Moultrie Courthouse is approximately 30 years old and, due to its age and the expanded electrical load from computers and other modern office equipment, the electrical system poses a serious threat to the health and safety of workers and building occupants.

The Courts' budget request includes several initiatives needed to keep our capital projects on the schedule established by our Facilities Master Plan that are not supported this year in the President's recommendation. These projects, such as the renovation of the Moultrie Courthouse and Building C (the old juvenile court), will need to be addressed in future years. As we have learned, any delay in construction projects significantly increases their cost.

RECENT ACHIEVEMENTS

As the Courts approach the tenth year of direct federal funding in fiscal year 2008, we look forward to building on past reforms that enhanced our services to the community and demonstrated our commitment to fiscal responsibility. We are proud of the Courts' recent achievements that all enhance public trust and confidence and that include the following:

—construction to restore the Old Courthouse, a building of historic and architectural significance that is critical to meeting the long term space needs of the Courts and to urban renewal in the District, following approval by the National

Capital Planning Commission, Commission of Fine Arts, and Historic Preservation Board;

—development and approval by the National Capital Planning Commission of a Master Plan for Judiciary Square, an urban design and renewal plan to revitalize this historic area of the District of Columbia that dates to the original L'Enfant Plan for the Nation's Capital;

—initiation of our second five-year strategic plan, Committed to Justice in the Nation's Capital, to ensure that the Courts' goals, functions, and resources are strategically aligned to our budget and our operations for maximum efficiency and effectiveness through 2012;

—adoption of 13 courtwide performance measures which will enhance the Courts' ability to monitor and assess case management activities and, ultimately, to inform the public about our performance;

—comprehensive space renovation, including mechanical, electrical and security upgrades; new space for the Landlord Tenant and Small Claims courts and juvenile probation (the Social Services Division of the Family Court) in Building B; and renovated space in Building A for the Crime Victims Compensation Program and the Multi-Door Division, as the Courts' Facilities Master Plan is implemented.

—Full implementation of the Family Court Act, including a newly constructed, family friendly facility on the JM level of the Moultrie Courthouse in fiscal year 2004, which houses the new Central Intake Center to provide one-stop public service; implementation of the one family-one judge principle; development of attorney practice standards and creation of attorney panels for neglect and juvenile cases; establishment of a Family Treatment Court for mothers with substance abuse issues and their children; creation of a Self-Help Center for unrepresented litigants; opening the Mayor's Services Liaison Center in the courthouse to coordinate the provision of needed social services; transferring all required children's cases to Family Court judges; and installation of a family sculpture at the reconfigured entrance to the Family Court;

—establishment of the District of Columbia Access to Justice Commission, by the Court of Appeals, to enhance access to civil justice for all persons without regard to economic status;

—inauguration of Court of Appeals Education Outreach Initiative, which includes oral arguments in the community at law schools located in the District of Columbia followed by opportunities for students to ask the judges questions about appellate advocacy;

—initiation by the Court of Appeals of web-streaming oral arguments, giving the public real-time access, on the Internet, to oral arguments before the Court;

—implementation by the Court of Appeals of a comprehensive revision of its rules of practice to reduce expenses associated with record preparation, the first such revision since the mid-1980's;

—development and implementation of a appellate mediation program to assist parties in reaching satisfactory case outcomes more expeditiously, thereby saving the public and the Court of Appeals time and money;

—installation and conversion to a new case management system in the Superior Court, CourtView, through the Integrated Justice Information System (IJIS) project which consolidates 19 distinct automated databases into one comprehensive system, thereby ensuring complete information on all cases pertaining to one individual or family to enhance case processing and judicial decision-making;

—revision of the Criminal Justice Act Plan to improve quality legal representation for indigent criminal defendants in the Court of Appeals;

—continued enhancements to the Courts' website, designed to increase public information and access, including implementation of on-line juror services and recognition by Justice Served as one of the top ten court websites worldwide;

—implementation of two community courts, the D.C. and Traffic Community Court and the East of the River Community Court, to enhance responsiveness to the community and to address quality of life crimes through a blend of therapeutic justice and restorative justice;

—creation of a Landlord Tenant Resource Center and a Small Claims Resource Center to provide free legal information to unrepresented parties and referrals to legal and social service providers;

—promulgation of draft probate attorney practice standards and creation of the Probate Review Task Force, to enhance service to incapacitated adults and other parties in probate cases;

—disposition of 1,443 cases and receipt of 1,541 filings in the Court of Appeals, and disposition of 136,413 and receipt of 128,468 filings in the Superior Court

(fiscal year 2005 statistics), continuing operation as one of the busiest courthouses in the nation (Superior Court judges hear more cases, on average, than judges in all but eight states, and case filings per capita in both the trial and appellate courts rank at or near the highest in most categories, as examined by the National Center for State Courts).

D.C. COURTS INFRASTRUCTURE

The Courts' capital budget has been a primary focus of our budget request for several years. The District of Columbia Courts serve approximately 10,000 courthouse visitors each day, process more than 150,000 cases each year, and employ a staff of 1,200 who directly serve the public, process the cases, and provide administrative support. As noted above, the District of Columbia Courts are among the busiest and most productive court systems in the United States.

The Courts' capital needs are significant because we are responsible for 1.1 million gross square feet of space in Judiciary Square and five buildings, including the Moultrie Courthouse, one of the busiest and most heavily visited public buildings in the District of Columbia. The ages of the Courts' buildings ranges from 30 years to 200 years. Our funding requirements include projects critical to maintaining, preserving, and building safe and functional courthouse facilities essential to meeting the heavy demands of the administration of justice in our Nation's Capital. To effectively meet these demands, the Courts' facilities must be both functional and emblematic of their public significance and character.

Facilities that provide adequate and efficiently designed space are essential to enhance the administration of justice, simplify public interaction with courts, and improve access to justice for all. In contrast, facilities with inadequate space for employees to perform their work, with evidence of long-deferred maintenance and repair, and with inefficient layouts can detract from the public perception of the dignity and importance of a court and impair its ability to function in the community. This negative perception impacts public trust and confidence in courts, a nationally recognized critical requirement for the effective administration of justice. The National Center for State Courts succinctly states the relationship between courts and their facilities:

"Court facilities should not only be efficient and comfortable, but should also reflect the independence, dignity, and importance of our judicial system . . . It is difficult for our citizens to have respect for the courts and the law, and for those who work in the court, if the community houses the court in facilities that detract from its stature." [1]

Deferred maintenance forced by limited financial resources over many years left these buildings in a state that may be perceived to detract from the stature of the Courts. We are beginning to see improvements, thanks to your support in recent years, but much work remains to be done. The Courts' fiscal year 2008 budget request seeks resources to meet health and safety building codes and to provide secure facilities for the public. For example, adequate ventilation must be provided in the courthouse buildings. Electrical systems must be upgraded, both to meet modern office needs and to limit risk of fire. Safety hazards posed by disintegrating flooring materials must be remedied. The halls of justice in the District of Columbia must be well maintained, efficient, and adequately sized to inspire the confidence of the members of the public who enter our buildings. The Courts' facilities plans will, over a ten-year period, meet the well-documented space needs of the Courts and return the buildings to a condition that inspires trust in the justice system of the Nation's Capital.

The Courts' facilities plans will also enhance the efficient administration of justice and improve public access to justice in this jurisdiction by co-locating related functions. The restoration of the Old Courthouse for the Court of Appeals, for example, will provide the public with a single location for services that are currently found on different floors and in different buildings from most Court of Appeals offices. Offices related to the Family Court, such as juvenile probation, will be consolidated in the Moultrie Courthouse, which will be made possible only as we renovate space in other buildings, converting usage to public court proceedings and relocating operations from Moultrie. More efficient location of these offices will not only facilitate public access to the Courts, but will also enhance the efficiency of operations.

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[1] Don Hardenbergh with Robert Tobin, Sr. and Chang-Ming Yeh, *The Courthouse: A Planning and Design Guide for Court Facilities*, National Center for State Courts, 1991, p. xiii.

In addition, basic mechanical systems impact the administration of justice. A broken air conditioning or heating system, for example, can force suspension of trials when courtroom temperatures reach unbearable levels.

Facilities in the Courts' Strategic Plan

The capital projects included in this request are an integral part of the Courts' Strategic Plan, completed in fiscal 2003. I am pleased to have co-chaired the Strategic Planning Leadership Council, which, with broad input from the community, developed the Strategic Plan of the D.C. Courts, entitled Committed to Justice in the Nation's Capital. The Strategic Plan articulates the mission, vision, and values of the Courts in light of current initiatives, recent trends, and future challenges. It addresses issues such as implementation of a Family Court, increasing cultural diversity, economic disparity, complex social problems of court-involved individuals, the increasing presence of litigants without legal representation, rapidly evolving technology, the competitive funding environment, enhanced public accountability, competition for skilled personnel, and increased security risks.

Facility improvements were identified as a high priority among all constituency groups surveyed by the Courts as the Strategic Plan was developed. Employees, judges, and stakeholders were asked to identify the most important issues the Courts must address in the coming years, and each ranked "enhance court facilities" among the highest priorities. In addition, approximately half of judges and 65 percent of employees reported inadequate light, heat, air conditioning, and ventilation in their workspaces.

"Improving Court Facilities and Technology" is the Plan's Strategic Issue 4. The Strategic Plan states—

"The effective administration of justice requires an appropriate physical and technical environment. Court personnel and the public deserve facilities that are safe, comfortable, secure, and functional, and that meet the needs of those who use them. Technology must support the achievement of the Courts' mission."

Historic Judiciary Square

The D.C. Courts are primarily located in Judiciary Square, with some satellite offices and field units in other locations. The historical and architectural significance of Judiciary Square lend dignity to the important business conducted by the Courts and, at the same time, complicate efforts to upgrade or alter the structures within the square. Great care has been exercised in designing the restoration of the Old Courthouse, the centerpiece of the square, to preserve the character not only of the building, but also of Judiciary Square. As one of the original and remaining historic green spaces identified in Pierre L'Enfant's plan for the capital of a new nation, Judiciary Square is of keen interest to the Nation's Capital.

Buildings A, B, and C, dating from the 1930's, are situated symmetrically along the view corridor comprised of the National Building Museum, the Old Courthouse, and John Marshall Park and form part of the historic, formal composition of Judiciary Square. The Moultrie Courthouse, although not historic, is also located along the view corridor and reinforces the symmetry of Judiciary Square through its similar form and material to the municipal building located across the John Marshall Plaza.

Judiciary Square Master Plan

The National Capital Planning Commission (NCPC) required that the D.C. Courts develop a Judiciary Square Master Plan—essentially an urban design plan—before any construction by the Courts and others could be commenced in the area. The D.C. Courts worked with all stakeholders on the Plan, including the United States Court of Appeals for the Armed Forces, the National Law Enforcement Officers Memorial Fund (Memorial Fund), the Newseum, and the Metropolitan Police Department. The Judiciary Square Master Plan was approved in August 2005.

The Judiciary Square Master Plan resolves important technical issues related to access, service, circulation, and security within a rapidly changing and publicly oriented area of the District, while re-establishing the importance of this historic setting in the "City of Washington." It provides a comprehensive framework for capital construction for all local entities, and it lays the groundwork for the regulatory approval process with the National Capital Planning Commission, the U.S. Commission of Fine Arts, the District of Columbia Office of Historic Preservation, the District of Columbia Office of Planning, and the District of Columbia Department of Transportation, among others. The Judiciary Square Master Plan will ensure the preservation of one of the last green spaces in the District of Columbia awaiting revitalization, incorporating areas where the public can gather and relax, and creating a campus-like environment where citizens can feel safe and secure.

Master Plan for D.C. Courts Facilities

The Courts worked with the General Services Administration (GSA) on a number of capital projects since fiscal year 1999, when the Courts assumed capital project responsibility from the District's Department of Public Works. In 1999, GSA produced a study for the renovation of the Old Courthouse to house the D.C. Court of Appeals. In 2001, GSA prepared Building Evaluation Reports that assessed the condition of the D.C. Courts' facilities. These projects culminated in the development of the first Master Plan for D.C. Courts Facilities, which delineates the Courts' space requirements and provides a blueprint for optimal space utilization, both in the near and long term.

The Master Plan for D.C. Courts Facilities (Facilities Master Plan), completed in December 2002, incorporates significant research, analysis, and planning by experts in architecture, urban design and planning. During this study, GSA analyzed the Courts' current and future space requirements, particularly in light of the significantly increased space needs of the Family Court. The Facilities Master Plan examined such issues as alignment of related court components to meet evolving operational needs and enhance efficiency; the impact of the D.C. Family Court Act of 2001 (Public Law Number 107–114); accommodation of the Courts' space requirements through 2012; and plans to upgrade facilities, including, for example, security, telecommunications, and mechanical systems. The Plan identified a space shortfall for the Courts of 48,000 square feet of space in 2002, with a shortfall of 134,000 square feet projected in the next decade.

The experts proposed to meet the Courts' space needs through three mechanisms: (1) renovation of the Old Courthouse for the District of Columbia Court of Appeals, which will free critically needed space in the Moultrie Courthouse for trial court operations; (2) construction of an addition to the Moultrie Courthouse, to include a separately accessible Family Court facility; and (3) the reoccupation and renovation of Building C, adjacent to the Old Courthouse. In addition, the Plan determined that all court facilities must be modernized and upgraded to meet health and safety standards and to function with greater efficiency.

Overview of the D.C. Courts' Facilities

The Courts currently maintain four buildings in Judiciary Square: the Old Courthouse at 430 E Street, the Moultrie Courthouse at 500 Indiana Avenue, N.W., and Buildings A and B, which are located between 4th and 5th Streets and E and F Streets, N.W. In addition, the District government has partially vacated Building C, which will soon return to the D.C. Courts' inventory.

Old Courthouse

The Old Courthouse, built from 1821 to 1881, is one of the oldest public buildings in the District of Columbia. Inside the Old Courthouse, Daniel Webster and Francis Scott Key practiced law and John Surratt was tried for his part in the assassination of President Abraham Lincoln. The architectural and historical significance of the Old Courthouse led to its listing on the National Register of Historic Places and its designation as an official project of Save America's Treasures. The unique character of the building, together with its compact size, makes it ideal for occupancy by the highest court of the District of Columbia. At the same time, the structure requires extensive work to meet health and safety building codes and to readapt it for modern use as a courthouse. The restoration of the Old Courthouse for use as a functioning court building will not only provide much needed space for the Courts, but it will also preserve a historic treasure of our nation and impart new life to one of the most significant historic buildings and precincts in Washington, D.C. It will meet the needs of the Courts and benefit the community through an approach that strengthens a public institution, restores a historic landmark, and stimulates neighborhood economic activity.

Moultrie Courthouse

The Moultrie Courthouse is uniquely designed to meet the needs of a busy trial court. It has three separate and secure circulation systems—for judges, the public, and the large number of prisoners brought to the courthouse each day. Built in 1978 for 44 trial judges, today it is strained beyond capacity to accommodate 59 trial judges and 24 magistrate judges in the trial court and 9 appellate judges, as well as senior judges and more than 1,000 support staff members for the two courts. Currently, the Moultrie Courthouse provides space for most Court of Appeals, Superior Court, and Family Court operations and clerk's offices. Essential criminal justice and social service agencies also occupy office space in the Moultrie Courthouse. The Courts have clearly outgrown the space available in the Moultrie Courthouse. The

space is inadequate for this high volume court system to serve the public in the heavily populated metropolitan area in and around our Nation's Capital.

Buildings A, B, and C

Buildings A, B, and C, dating from the 1930's, have been used primarily as office space in recent years and today are being renovated and modernized for court operations. The D.C. Courts have begun implementation of the Facilities Master Plan, relocating the Superior Court's two highest volume courtrooms, Small Claims and Landlord Tenant, into Building B. This move vacated space in the Moultrie Courthouse that was immediately renovated for the Family Court, permitting the construction of three new courtrooms, three new hearing rooms, a centralized case intake facility, a family-friendly waiting area, and District government liaison offices for Family Court matters. The first phase of restoration of Building A is complete; the Multi-Door Dispute Resolution Division moved late in 2006 and the Probate Court is scheduled to move to Building A later this year.

COMPLETE BUDGET REQUEST SUMMARY

To build on past accomplishments and to serve the public in the District of Columbia, the Courts require additional resources in fiscal year 2008 as outlined below. Without additional capital resources, the courthouse and the District's historic buildings will continue to deteriorate; without targeted investments in critical areas, the quality of justice in the Nation's Capital will be compromised. The fiscal year 2008 request addresses these requirements by:

—*Full Funding for Authorized Positions*.—To ensure the level of staffing needed for the Courts to fulfill its mission, the budget includes a special request for $8,432,000. All Court personnel, from judges in courtrooms and clerks at public service counters to managers and support staff, play important roles in the administration of justice in the District. The Courts' mission and strategic goals rely upon highly skilled personnel in sufficient numbers to serve the residents of this jurisdiction and visitors in the Nation's Capital. Unless this most critical issue facing the D.C. Courts is addressed, the Courts will be unable to fill mission-critical positions, and the quality of justice in the District of Columbia will be compromised.

Over several years, increasing personal services costs have outpaced appropriations, resulting in a significant funding shortfall in the Courts' personal services budget. Escalating benefit costs, particularly those for health insurance, underfunded cost of living adjustments (COLAs), and unfunded salary costs (e.g., overtime and night differential) all contribute to the personal services funding gap. The cost of benefits, for example, has increased by 43 percent from fiscal years 2001 to 2005 while personal services appropriations increased by only 13 percent. Cost-of-living-adjustments cost the Courts $8 million more than the funding provided, from fiscal years 2002 to 2006. Costs for salary components such as overtime have skyrocketed as well.

Because 75 percent of the Courts' budget is comprised of personal services costs, the shortfall has resulted in increased staff vacancies and a hiring freeze. Without the requested funding, the Courts predict a non-judicial vacancy or lapse rate of 15 percent in fiscal year 2008 compared to the government standard of 3 percent. Severe negative consequences on the administration of justice and disruptions to court operations would result from a reduction of nearly one in six persons.

The Courts have taken several steps to address the personal services budget gap, including reengineering business processes, deferring the 2007 cost of living adjustment, implementing a hiring freeze, seeking legislation for buyout authority, limiting travel and training opportunities, curtailing employee incentive awards, and reprogramming funds as permitted by law. However, additional funding is required to permit the Courts to maintain adequate staff to carry out our mission.

—*Infrastructure Investments*.—To ensure the health, safety, and condition of court facilities and to address operational space needs, the fiscal year 2008 capital request totals $179,790,000. The fiscal year 2008 capital request incorporates the significant research and planning comprising the Facilities Master Plan. In the master plan process, the General Services Administration (GSA) analyzed the Courts' current and future space requirements, particularly in light of the significantly increased space needs of the Family Court, and identified a 134,000 occupiable square feet shortfall over the next ten years. In addition to improved maintenance and upgrade of existing facilities, the Facilities Master Plan recommended a three-part approach to meeting the Courts' space shortfall: (1) restoration of the Old Courthouse at 451 Indiana Avenue to house the D.C. Court

of Appeals and to make additional space available in the Moultrie Courthouse for trial court operations; (2) an addition to the Moultrie Courthouse to accommodate fully consolidated and state-of-the-art Family Court facilities; and (3) reoccupation of Court Building C, adjacent to the Old Courthouse.

—*Old Courthouse*.—The Courts' capital request includes $30,000,000 for Old Courthouse restoration costs not included in the construction contract, such as wiring for security, technology and telecom equipment, construction management, and contingency and management reserves.[2]

—*Moultrie Courthouse*.—Also included in the capital budget request is $29.1 million to continue work on the Moultrie Courthouse, as delineated in the Facilities Master Plan. Renovation and reorganization of the interior of the Moultrie Courthouse is necessary to shift operations to vacate some of the space required to fully consolidate the Family Court within Moultrie and to upgrade and make efficient use of existing space as envisioned in the Facilities Master Plan.

—*Building Maintenance*.—The capital budget also includes $55,490,000 to maintain the Courts' existing infrastructure, preserving the health and safety of courthouse facilities for the public and the integrity of historic buildings for the community. The Courts' facilities encompass more than 1.1 million gross square feet of space. Over the course of many years, limited resources have forced the Courts to defer routine maintenance of these facilities, leading to increased risk of severe system failures. For example, electrical service to meet modern technology needs is critical, not only to conduct court business, but also to prevent failures that threaten safety, such as electrical fires or transformer explosions.

—*Homeland Security*.—To protect the 10,000 daily visitors to the courthouse and meet increased security threats that face the judiciary nationwide and public institutions post September 11, 2001, the Courts' request includes $16,000,000 in capital funds for perimeter security enhancements to protect the occupants of the high-profile court buildings in Judiciary Square.

—*U.S. Marshals Service Space*.—The U.S. Marshals Service provides security for the D.C. Courts and manages hundreds of prisoners who appear in court each day. The adult cellblock and Marshals Service office space in the Moultrie Courthouse require modernization and upgrade to comply with current standards. The Courts are working with the Marshals Service on a study to determine the requirements in a comprehensive manner. We initiated the study in March and expect it to be complete on May 3. Although the preliminary cost estimate is $42 million for the construction work, the additional cost of the security equipment has not yet been determined.

—*Furniture and Equipment for the Restored Old Courthouse*.—The Courts' request includes $2,589,000 to furnish and equip the Old Courthouse upon restoration. As noted above, the restoration of the Old Courthouse for this jurisdiction's highest court, the D.C. Court of Appeals, is in progress. To prepare to move into the structure and efficiently use the space as planned, furniture and equipment must be procured in fiscal 2008.

—*Services for Citizens*.—To enhance services to some of the District's most vulnerable residents, $2,184,000 and 10 FTEs are requested. This figure includes $853,000 and 2 FTEs to provide statutorily-mandated advocates for mentally retarded individuals who are wards of the District; $771,000 and 5 FTEs to provide services and additional probation officers for youths under court supervision; $375,000 for interpreters who provide sign language and foreign language interpretation for litigants; and $185,000 and 3 FTEs to enhance monitoring of the status of incapacitated adults with court-appointed guardians.

—*Technology, Financial, Materiel, and Facilities Management*.—To enhance technology, financial, materiel, and facilities management, $1,607,000 and 10 FTEs are requested. Included in the total are $331,000 for software maintenance fees for the trial court case management system (CourtView); $585,000 for warehouse space to store court records and materials, $363,000 and 6 FTEs for building engineers and services; $255,000 for accounting staff; and $73,000 for a materiel management function.

—*Built-In Increases*.—The fiscal year 2008 request also includes $4,155,000 for a cost-of-living adjustment, $1,630,000 for non-pay inflationary cost increases, and $1,412,000 for within-grade increases. The Courts' request includes within-grade increases for employees because unlike typical agencies, which may fund

[2] Because the Courts' budget submission was prepared before the fiscal year 2007 budget was enacted, it also includes $13 million to complete financing of the construction contract for the renovation.

these increases through cost savings realized during normal turnover, the Courts have a very low turnover rate (5.5 percent in fiscal year 2006), a hiring freeze, and a funding shortfall in personal services.

—*Defender Services Enhancements*.—In recent years, the Courts have devoted particular attention to improving the financial management and reforming the administration of the Defender Services programs. For example, the Courts have significantly revised the Criminal Justice Act (CJA) Plan for representation of indigent defendants to ensure that highly qualified attorneys represent indigent defendants. In addition, the Courts have developed a new Counsel for Child Abuse and Neglect (CCAN) Plan for Family Court cases, adopting attorney practice standards and requiring attorney training and screening to ensure that well-qualified attorneys are appointed in these cases, and contracting for Guardian ad litem (GAL) services to enhance representation of abused and neglected children. The Guardianship Program has also been revised, imposing a training requirement on attorneys participating in the program.

In the Defender Services account, the Courts' fiscal year 2008 budget request represents an increase of $9,000,000 over the fiscal year 2007 level. This increase reflects a compensation adjustment for attorneys from $65 to $90 per hour, to keep pace with the rate paid court-appointed attorneys at the Federal courthouse across the street from the D.C. Courts and to ensure that the indigent receive high quality legal representation.

CONCLUSION

Mister Chairman, Senator Brownback, Subcommittee members, the District of Columbia Courts have long enjoyed a national reputation for excellence. We are proud of the Courts' record of administering justice in a fair, accessible, and cost-efficient manner. Adequate funding for the Courts' fiscal year 2008 priorities is critical to our success, not only in the next year but also as we implement plans to continue to provide high quality service to the community in the future. We appreciate the President's support for the Courts' funding needs in 2008 and the support we have received in the past from the Congress. We look forward to working with you throughout the appropriations process, and we thank you for this opportunity to discuss the fiscal year 2008 budget request of the District of Columbia Courts.

Senator DURBIN. Judge King, many years ago we worked together in the creation of the Family Court and I welcome you today.

STATEMENT OF RUFUS G. KING III, CHIEF JUDGE, SUPERIOR COURT OF THE DISTRICT OF COLUMBIA

Judge KING. We did indeed, Mr. Chairman and we at the Superior Court are very grateful for the contributions you made to that very successful legislation.

Mr. Chairman, subcommittee members, thank you for this opportunity to discuss the fiscal year 2008 budget request of the District of Columbia Courts. I'm Rufus G. King III, Chief Judge at the Superior Court of the District of Columbia, the city's trial court.

OPERATING BUDGET PRIORITIES

Chief Judge Washington's statement on behalf of the Joint Committee on Judicial Administration details both courts' complete budget request, so I will highlight Superior Court issues. The highest priorities described by Chief Judge Washington are also critical to the Superior Court.

The personal services budget shortfall that Chief Judge Washington described has had a negative impact in both courts, but its impact on the trial court has been especially severe. In the Superior Court, more than one in eight positions is vacant and in every area of court operations the effect is being felt. I cannot overstate the importance of court staff to trial court operations. Judges in the courtroom can only do their jobs sufficiently and effectively when

supported by adequate staff. The Superior Court prides itself on innovative programs designed to respond to the needs of the community we serve. For example, our domestic violence unit provides access to law enforcement and social service assistance in the courthouse and at a satellite center in Southeast, where many of the victims live.

FAMILY COURT UPDATE

More than 5 years into the development of the Family Court, we have implemented every aspect of the Family Court Act of 2001 and continue to look for improvements. This year, we opened a Balanced and Restorative Justice Drop-In Center in Anacostia, which offers services for the rehabilitation of juveniles, including probation supervision, tutoring, mentoring, peer mediation, and field trips for youths and their families.

We have opened a Family Court Self-Help Center, in addition to ones that we've opened in Landlord Tenant Court, Small Claims Court, and Probate Court. In this self-help center, employees work with volunteer attorneys to provide unrepresented litigants with legal information on family law matters.

We have established a Family Treatment Court to help mothers with substance abuse issues without separating them from their children. The court has developed attorney practice standards and created attorney panels for neglect cases in the Family Court and juvenile cases, as well as for the probate and criminal bar to better assure adequate legal representation for litigants in these vital areas.

All of these programs rely on staff to serve the public directly, to coordinate pro bono services with the bar and private organizations, and to collaborate with other Government agencies. We are leveraging grant funds and pro bono services as much as we can, but the Superior Court must have adequate staff to carry out its mission of administering justice in the Nation's capital. For that the $8.4 million we've requested is critical.

On the capital side, the new family friendly facility on the JM level of the Moultrie Courthouse houses the new Central Intake Center for all Family Court clerk's office functions. The Mayor's Services Liaison Center coordinates provision of social and other services by our District of Columbia partner agencies. Earlier this year, we completed its build out with the unveiling of a new family sculpture at the entrance to the Family Court.

CAPITAL BUDGET PRIORITIES

Restoration of the old courthouse for the Court of Appeals will benefit the Superior Court as well as the Court of Appeals by freeing up approximately 37,000 square feet of space in the Moultrie Courthouse for trial court operations. This will allow us to complete consolidation of the Family Court, while also addressing other space needs in the Superior Court.

CONCLUSION

In conclusion, Mr. Chairman, the Superior Court is proud of our efforts to enhance the administration of justice and to be respon-

sive to the community we serve. We appreciate the support Congress and the President have shown in helping us carry out our goals and we believe we have been good stewards of the taxpayers hard-earned funds.

PREPARED STATEMENT

Thank you for this opportunity to address the subcommittee. I'd be happy to answer any questions you might have.

Senator DURBIN. Thank you, Judge King.

[The statement follows:]

PREPARED STATEMENT OF CHIEF JUDGE RUFUS G. KING III

Mr. Chairman, Senator Brownback, subcommittee members, thank you for this opportunity to discuss the fiscal year 2008 budget request of the District of Columbia Courts. I am Rufus G. King III, Chief Judge of the Superior Court of the District of Columbia. As you know, the Superior Court is the trial court for the District of Columbia. It is a unified court of general jurisdiction, hearing matters brought to court under all areas of District of Columbia law.

Chief Judge Washington's statement on behalf of the Joint Committee on Judicial Administration details the Courts' complete budget request, so I will highlight Superior Court issues as part of the larger D.C. Courts budget request and capital project needs.

The personal services budget shortfall that Chief Judge Washington described has had a negative impact courtwide. For the Superior Court, this shortfall has resulted in a 13 percent vacancy rate today, meaning that one in eight non-judicial positions are vacant. Every area of court operations is suffering from these excessive vacancies. We are leveraging grant funds and pro bono services as much as we can, but the Court must have adequate staff to carry out its mission of administering justice in the Nation's Capital.

RESPONSIVENESS TO THE COMMUNITY

The Superior Court prides itself on innovative programs designed to respond to the needs of the community we serve. I would like to share with you a few of the programs, some mentioned in Chief Judge Washington's statement, that the Superior Court has put in place to support our strategic goals of increasing public access and enhancing public trust and confidence in the courts.

Self-Help Centers

Tens of thousands of individuals come to the Superior Court each year to have their disputes resolved without the assistance of an attorney. The Court has teamed with the D.C. Bar and local law schools to provide resource centers to assist these self-represented litigants as they navigate the court system.

—The Landlord Tenant Resource Center uses volunteer attorneys to provide legal information to landlords and tenants without lawyers. Services include helping them understand the court proceedings, helping them prepare pleadings, giving advice on how to present their cases, making referrals to legal service providers or social services resources.

—The Small Claims Resource Center is a collaborative effort with the D.C. Bar Pro Bono Program, the Neighborhood Legal Services Program, and local law schools to assist litigants with small claims cases at the court. Volunteer attorneys help self-represented litigants understand the court proceedings, help them prepare documents, give them advice on how to present their cases, and make referrals to legal service providers.

—The Family Court Self-Help Center provides free walk-in service to self-represented litigants with general legal information on family law matters, such as divorce, custody, visitation, child support. Court staff members inform litigants of their rights and obligations, describe legal options, help litigants identify which forms to use, and make referrals.

Satellite Offices

The Domestic Violence Unit operates a Domestic Violence Satellite Center at Greater Southeast Hospital to provide a community-based alternative location to the courthouse for victims of domestic violence. This office provides easy access to the Superior Court for victims of domestic violence who reside east of the Anacostia

River, where 60 percent of those filing domestic violence cases live. Both the Satellite Center and the Domestic Violence Intake Center at the courthouse involve collaborations with other government and community groups to provide "one-stop-shopping" for victims of domestic violence to help them access needed social services and law enforcement resources.

The Court operates three juvenile probation field units, where young people meet with their probation officers and attend programs in or near their own neighborhoods. Our Family Court Social Services Division is restructuring the manner in which probationers are supervised and rehabilitated to adopt a more holistic approach that, we believe, will result in better outcomes. In February, the Court opened the first Balanced and Restorative Justice Drop-In Center, which includes a probation supervision office and a community-based satellite courtroom and offers services including tutoring, mentoring, education and prevention groups, peer mediation, recreation, and field trips to youth and their families.

Specialized Courts

The Court stays abreast of best practices among courts nationwide and has several programs that combine therapeutic and restorative justice principles to improve public safety in our community and to enhance case outcomes for litigants. In addition to the drug courts we have operated for many years, we have three more recent programs.

—The Family Treatment Court, which celebrated its 7th graduation ceremony last November, helps keep children out of foster care and with their mothers (or other female guardians) while providing substance abuse treatment to the parent. In the Family Treatment Court, a collaborative program with the Mayor's Service Liaison Office, the children live with their mothers in a residential substance abuse treatment program. The treatment facility provides on-site and community-based services, including substance abuse education and treatment, parenting skill workshops, counseling and childcare.

—The Truancy Court is a diversion program designed to increase school attendance and improve academic performance and behavior of at-risk children. In collaboration with several D.C. government agencies, Family Court judges meet weekly with children at Garnett Patterson Middle School and Kramer Middle School and, through rewards and corrective actions, promote compliance with a school attendance plan of action developed for each child and family.

—Two criminal Community Courts, the D.C./Traffic Community Court and the East of the River Community Court, focus largely on quality-of-life offenses such as possession of an open container of alcohol, aggressive panhandling, disorderly conduct, and low-level theft, through a variety of responses. These community courts frequently require community service to "pay back" the community. They also seek to reduce the likelihood of future offenses by linking offenders with services they may need, such as drug treatment, job training, and mental health services. Community input is a key element of the community court. At town hall meetings judges go to the community to listen to their concerns and learn what the court can do to strengthen our communities and to improve public confidence in the justice system.

TECHNOLOGY

To enhance service to the public, to operate more efficiently, and to support our strategic goal of improving court technology, the Court has undertaken a number of technology initiatives. I would like to highlight a few of these.

Integrated Justice Information System (IJIS)

I am very pleased to report that we have completed implementing the Integrated Justice Information System (IJIS) throughout the Superior Court. This multi-year technology initiative was designed to facilitate case management and linkage of family members (which is essential to implementing the one family, one judge principle in Family Court), to enhance automation of the Court's business processes, to equip employees with productivity-enhancing tools, to provide a seamless exchange of information between the Court and other local and national criminal justice agencies, and to enhance services to the public by, among other things, enabling case filing and payment of fees in one location. As IJIS is enhanced, electronic case access and filing will be available through the Internet. IJIS has consolidated 19 different databases and provides comprehensive information to judicial officers. IJIS implementation has also given us an opportunity to improve information sharing within and among the District's child welfare and criminal justice agencies.

E-filing

In a related step in the automation of case processing, the Superior Court last fall expanded e-filing. After a transition period, e-filing became mandatory for Civil II cases for parties represented by counsel. E-Filing provides the public and the legal community with user-friendly, low-cost access to the Courts. The new system allows documents filed with the Superior Court to be transmitted over the web for acceptance into the IJIS. The system generates electronic notifications to all parties, as well as to the judge in the case. E-filing was implemented in the Superior Court in May 2005 to increase the timeliness, efficiency, and accuracy of court filing.

Web-based Juror Services

To enhance services for jurors, the Court initiated an interactive juror website that allows jurors to view their last or next scheduled date of service, complete the juror questionnaire, and defer their service for up to 90 days online.

CONCLUSION

Mr. Chairman, Senator Brownback, the D.C. Superior Court is proud of our efforts to enhance the administration of justice, to be responsive to the community we serve, and to implement technology that enhances our service to the public. We appreciate the support Congress and the President have shown in helping us carry out all of those goals, and we believe we have been good stewards of the taxpayers' hard-earned funds. We hope that the Court's request for funding for personal services adequate to bring our vacancy rate down from 13 percent to a more normal 3–4 percent will meet with the subcommittee's approval.

Thank you for this opportunity to address the subcommittee. I would be pleased to answer any questions you may have.

Senator DURBIN. Mr. Quander.

STATEMENT OF PAUL A. QUANDER, JR., ESQ., DIRECTOR, COURT SERVICES AND OFFENDER SUPERVISION AGENCY

Mr. QUANDER. Good afternoon, Mr. Chairman. I'm pleased to appear before you today to present the fiscal year 2008 budget request for the Court Services and Offender Supervision Agency for the District of Columbia, which includes the District of Columbia Pre-Trial Services Agency.

CSOSA's fiscal year 2008 budget request of $190.3 million includes $140.4 million for the Community Supervision Program, which supervises sentenced offenders in the community on probation, parole or supervised release, and $49.9 million for the Pretrial Services Agency, which supervises and monitors pre-trial defendants.

Our fiscal year 2008 request increases total funding by 6 percent or $10.7 million over fiscal year 2007. The majority of the requested increase, $6.2 million, will enable us to absorb salary and general schedule cost increases without curtailing program services.

The Community Supervision Program requests an additional $2.1 million adjustment to base to achieve full implementation of a major program enhancement, our Residential Re-entry and Sanctions Center (RSC). This increase will allow us to open the Reentry and Sanctions Center's sixth and final unit which will serve the female offender and defendant populations.

The RSC, as the center is commonly referred to, is a tremendous resource for CSOSA and the citizens of the District of Columbia. It will enable us to provide re-entry programming for high risk offenders and defendants at the point of release. We can also respond quickly to noncompliant behavior, intervening before new criminal activity occurs. Research tells us that both strategies are critical to successful supervision.

When CSOSA was established in 1997, reducing the high caseload of probation and parole officers was a top priority. While we have lowered general supervision caseloads to the 50 cases per officer recommended by the American Probation and Parole Association, high pre-trial defendant caseloads continue to pose a serious risk to public safety.

The Pretrial Services Agency's general supervision units supervise or monitor approximately 3,500 defendants on each and every day. In fiscal year 2006, many pre-trial supervision officers in these units carried an average caseload of 115 defendants. At this level meaningful supervision cannot be maintained.

In choosing to impose pre-trial supervision, the court assumes that release conditions will be enforced and infractions will be reported. With the current high caseloads, PSA is not able to provide the level of supervision that the court expects.

PSA requests $1.6 million and nine full-time equivalent positions to lower its general supervision caseloads to 75 defendants per pretrial supervision officer. While still higher than neighboring jurisdictions, this caseload will result in closer supervision and more timely response to infractions.

Technology is an essential component of effective supervision. PSA also requests $768,000 and three full-time equivalent positions to expand the technology available to pre-trial services officers. This request would add wireless cellular and global positioning systems monitoring capability to PSA's existing electronic monitoring program.

Wireless cellular technology extends electronic monitoring to defendants who do not have a hard wired home telephone. Global positioning system (GPS) monitoring would allow PSA to quickly determine a defendant's location and track his or her movements. In addition, GPS monitoring can be used to notify authorities when a defendant violates a court order by approaching a school, known drug area or victim's home.

In the 10 years since its founding, CSOSA has transformed community supervision in the District of Columbia. As a young agency we are still building critical elements of our infrastructure. Initiatives such as information technology, disaster recovery, fully modernized personnel and financial information systems and other enhancements are essential to ensuring our full compliance with Federal regulations.

We also face continued facility challenges, particularly at 300 Indiana Avenue—the building that we share with the Metropolitan Police Department.

In closing I would like to thank the ranking member, Senator Brownback for his past efforts to make funding available to us for transitional housing. Lack of appropriate, affordable housing continues to be a major obstacle to successful re-entry.

PREPARED STATEMENT

CSOSA's fiscal year 2008 budget enables us to continue implementing proven strategies to protect the public through effective community supervision. We look forward to the subcommittee's support of this request and I look forward to responding to any questions that this subcommittee may have. Thank you very much.

Senator DURBIN. Thanks, Mr. Quander.
[The statement follows:]

PREPARED STATEMENT OF PAUL A. QUANDER, JR.

Chairman Durbin and Members of the Subcommittee: I am pleased to appear before you today to present the fiscal year 2008 budget request for the Court Services and Offender Supervision Agency (CSOSA), which includes the D.C. Pretrial Services Agency (PSA). CSOSA was established by the National Capital Revitalization and Self-Government Improvement Act of 1997 (the Revitalization Act). Following a three-year transition period under the leadership of a trustee, CSOSA was certified as an independent Executive Branch agency on August 4, 2000.

CSOSA's fiscal year 2008 budget request of $190.3 million is comprised of a $140.4 million request for the Community Supervision Program, which supervises sentenced offenders in the community on probation, parole, or supervised release, and a $49.9 million request for PSA, which supervises and monitors pretrial defendants. Our fiscal year 2008 request increases total funding by 6 percent, or $10.7 million, over fiscal year 2007 enacted levels.

The majority of the requested increase, $6.2 million, would enable us to absorb salary and General Schedule cost increases without curtailing program services. The Community Supervision Program requests an additional $2.1 million adjustment to base to achieve full implementation of a major program enhancement, our residential Reentry and Sanctions Center (RSC). This increase will allow us to open the RSC's final unit, making the program model, which emphasizes intensive assessment, case planning, and treatment readiness services, available to the female offender population. We look forward to having all six units in operation.

The RSC is a tremendous resource for CSOSA, enabling us to provide reentry programming for high-risk offenders at the point of release, thereby increasing the likelihood that they will succeed in the community. This program is also available to high-risk defendants on pretrial release. Most individuals who complete the program then enter CSOSA's substance abuse treatment continuum. They often require placements in residential, transitional, and outpatient services to complete treatment. CSOSA continues to look at ways to maximize treatment efficiency and ensure that we make as many successful placements as possible.

The RSC also facilitates our quick response to defendants' and offenders' non-compliant behavior before it escalates and leads to new criminal activity. Research tells us that timely intervention and consistent sanctions are critical to effective community supervision. With the RSC, CSOSA has greatly increased its capacity to provide both.

When Congress passed the Revitalization Act in 1997, one of the most distressing conditions facing the new agency was the high caseloads carried by D.C.'s probation and parole officers. In many instances, these caseloads, often exceeding a hundred cases per officer, prohibited meaningful levels of contact and monitoring. Probation and parole officers could often do little more than check for new warrants and process paperwork. Meaningful assessment, referrals to treatment and other services, and field visits were virtually impossible.

The Community Supervision Program therefore made lower caseloads its first priority. General supervision caseloads have been lowered to the 50 cases per officer recommended by the American Probation and Parole Association. Specialized caseloads, for higher-risk offenders or those with significant mental health issues, are even lower.

These lower caseloads, coupled with improved technology, have enabled our officers to implement a level of intervention that was previously unthinkable. In fiscal year 2006, Community Supervision Officers partnered with Metropolitan Police Department (MPD) officers on over 7,000 joint field visits, or accountability tours, monitoring over 4,000 high-risk cases. This year, we also implemented an automated assessment instrument that uses over 200 separate data elements, collected during an in-depth interview with the offender, to measure and score the offender's risk level. This data informs a prescriptive supervision plan that addresses each offender's programming needs. Without this level of contact or knowledge, we cannot hope to achieve our long-term goal of substantially reducing recidivism among the 15,000 offenders we supervise, of whom 6,300 are classified as high-risk. Lower caseloads are the baseline condition necessary for us to achieve our public safety mission.

The high-risk defendants under PSA's supervision pose a similar risk to public safety. PSA supervises or monitors approximately 5,500 men and women every day. Approximately 3,500 of them are assigned to PSA's General Supervision Units. In fiscal year 2006, many Pretrial Supervision Officers (PSOs) in those units carried an average caseload of 115 defendants—significantly above the level at which proba-

tion and parole caseloads were once deemed too high to maintain meaningful supervision.

Defendants released to General Supervision have been charged with a range of offenses. In fiscal year 2006, 28 percent of those cases were charged with crimes that are statutorily defined as dangerous and/or violent; 37 percent were charged with crimes against persons. Even though many of these defendants are potentially eligible for pretrial detention, the Court has determined that initial, supervised placement in the community is appropriate. In making that determination, however, the Court expects that supervision will occur, conditions of release will be enforced, and non-compliance will be reported promptly.

With the current high caseload ratios, PSA is not able to provide the supervision that the Court expects. In fiscal year 2006, 48 percent of defendants released with drug testing conditions were non-compliant three or more times. Each of these violations warranted a response by the PSO. With such high caseloads, PSOs often cannot respond quickly, despite the statutory requirement that every violation be reported to the prosecutor and the Court.

PSA data from fiscal year 2004 reveals that timeliness is particularly important when the defendant has a history of domestic violence. Of 400 defendants with domestic violence charges who were rearrested while on pretrial release, about a third were rearrested for another domestic violence incident. These rearrests also tended to occur earlier in the supervision period than rearrests of defendants with other charges.

PSA requests $1.6 million and 9 FTE to lower its General Supervision caseloads to 75 defendants per PSO. While still higher than neighboring jurisdictions, this caseload will facilitate closer supervision and more timely response to infractions. Nationwide, federal pretrial supervision caseloads range from 40 to 75 cases per officer. Defendants prosecuted in the District of Columbia typically have more extensive prior criminal records than do defendants in federal courts, and are often in need of employment, education, and treatment services. Effective supervision of these defendants cannot take place with caseloads higher than 75 cases per officer.

Technology is an essential component of effective supervision and can greatly improve the officer's ability to monitor behavior. PSA also requests $768,000 and 3 FTE to expand technological tools available to Pretrial Service Officers. This request would fund the addition of wireless cellular and Global Positioning Systems (GPS) monitoring to PSA's existing electronic monitoring program. These two newer, more effective technologies are currently being used in many jurisdictions to monitor defendants who cannot be effectively supervised using traditional electronic monitoring. Wireless cellular technology extends this type of monitoring to defendants who do not have a hard wired home telephone. GPS monitoring would allow PSA to quickly determine the location of a defendant at any time as well as track his or her movement. In addition, GPS monitoring can be used to notify the authorities when a defendant enters restricted areas, such as schools, known drug areas, or a victim's neighborhood, in violation of the court's orders. Combining reduced caseloads with technological enhancements will enable PSA to achieve maximum efficiency in the supervision of high-risk defendants. GPS supervision has proven very effective in the Community Supervision Program, where it is primarily used as a short-term sanction for high-risk offenders.

Since becoming a federal agency in August 2000, CSOSA has transformed community supervision in the District of Columbia. Using best practices, advanced technology, and wide-ranging collaborations, we are helping the men and women we supervise to change their lives. In doing so, we make a positive impact on our city and our field. People are hearing our message: After CSOSA's presentation on partnerships at last summer's Black Police Association International Education and Training conference, a delegation from the United Kingdom's National Probation Service arranged to spend a week with us. They have taken our program model back home to Manchester, England, to inform how community supervision occurs there.

We look forward to demonstrating the results of our efforts. We will soon complete our initial three-year recidivism study. Later this spring, we will implement a performance accountability system modeled on New York State's "Parole Stat." We recently completed the first phase of a comprehensive study of our supervision practices. And we continue to work with our partners in implementing new and promising strategies: Through the Criminal Justice Coordinating Council, we are currently working with the U.S. Marshals Service, the U.S. Parole Commission, the D.C. Superior Court, the U.S. Attorney, the MPD, and the Washington faith community to bring Fugitive Safe Surrender to our city. This program, which has resulted in the surrender of thousands of fugitives with non-violent and misdemeanor warrants, has been successfully implemented in Cleveland and Phoenix, and is also

planned for Indianapolis. I am committed to bringing it to the District of Columbia. Not only will it safely remove fugitives from our streets, it will also give many of these men and women the opportunity to reclaim their identities and re-enter their communities.

As a young agency, we have made substantial progress, though much work remains to be done. Some critical elements of our infrastructure—such as Information Technology (IT) disaster recovery, fully modernized personnel and financial information systems, and other enhancements necessary to ensure our full compliance with federal regulations—are still being implemented. We also face continued facilities challenges, particularly at 300 Indiana Avenue, the building we share with the Metropolitan Police Department. Addressing these issues is essential to our continued maturation as an agency.

In 1997, the District of Columbia faced a community supervision system that was overburdened and under-resourced. We have revived that system, turning the nation's capital into a national leader. Our fiscal year 2008 budget enables the continued implementation of these proven strategies. We look forward to the subcommittee's support of this request.

Senator DURBIN. Ms. Buchanan.

STATEMENT OF AVIS E. BUCHANAN, ESQ., DIRECTOR, PUBLIC DEFENDER SERVICE

Ms. BUCHANAN. Good afternoon, Mr. Chairman. My name is——

Senator DURBIN. If you'll make sure you activate the mic, thank you.

Ms. BUCHANAN. Thank you. Good afternoon, Mr. Chairman. My name is Avis Buchanan and I have the honor of serving as the Director of the Public Defender Service for the District of Columbia. I come before you today to provide testimony in support of PDS's fiscal year 2008 budget request.

The Public Defender Service for the District of Columbia, or PDS, is an independent legal organization governed by a Board of Trustees. PDS is widely recognized as one of the best public defender offices in the country and is, in my humble opinion, the best.

In the District of Columbia both PDS and the local courts separately provide constitutionally mandated defense representation to people who cannot afford to pay for their own attorney. Under the District's Criminal Justice Act, the courts appoint PDS generally to the more serious, more complex, more resource intensive and time consuming criminal cases.

The courts assign the remaining, far more numerous but less serious cases and almost all of the misdemeanor and traffic cases, to a panel of approximately 350 prescreened private attorneys who was appointed to cases under the District's Criminal Justice Act and who are known as CJA attorneys. This dual system of representation is used in the Federal criminal justice system and is the model favored by the American Bar Association as an effective and cost efficient system.

Approximately 110 staff attorneys at PDS and a similar number of administrative staff represent children and adults in the most serious felony cases, criminal appeals, serious delinquency cases, parole revocation matters, involuntary civil commitment cases in the mental health system and the Superior Court's Drug Court Treatment Program.

Our fiscal year 2008 budget request parallels our request for fiscal year 2007: $32.7 million or 5 percent above the enacted level for fiscal year 2007, which was a level of $30.9 million.

With these funds PDS will absorb salary and inflationary increases to continue to improve our human capital management and comply with the D.C. Court of Appeals' request to do more to help reduce the backlog of cases pending before that court—all while sustaining the high quality advocacy that the criminal justice system is accustomed to seeing from PDS.

FAVORABLE SURVEY RESULTS

PDS's fiscal year 2006 accomplishments are exemplified in the results of two surveys PDS conducted as part of its strategic planning work.

During fiscal year 2006, we asked our counterparts in the CJA bar and some of our clients about their opinions of the quality of PDS's representation. Of the CJA bar respondents, 95 percent agreed that PDS attorneys provide and promote quality representation to indigent adults and children facing a loss of liberty. Ninety-three percent agree that PDS promotes society's interest in the fair administration of justice. Over 90 percent agree that the training PDS provides to the CJA bar is effective and relevant to defending their clients.

The client survey yielded one particularly compelling comment, slightly edited for clarity.

"To give you a sense of just how satisfied I am with the D.C. PDS, you must understand that I was convicted of three life offenses. I will most likely die in prison. I know that most clients cannot appreciate just how good the quality of PDS is. Had I been a rich man, if I'd had an obscene amount of money to pay a WASPy, white shoe firm, I could not have gotten a better defense. I was defended with an aggression by lawyers that showed a range and depth of knowledge and experience that I had never before witnessed in a member of the civil service."

These survey results are consistent with the results of a survey of local, trial, and appellate judges that PDS conducted in 2004. One appellate judge wrote, "Of all the litigants' counsel to come before the Court of Appeals on a regular basis, PDS lawyers are uniformly better. They give this judge, and I believe all judges, a sense that their clients are soundly and zealously represented while giving the court considered legal arguments. If I were facing prosecution in the District, I would want PDS to represent me."

I continue to be proud of the extraordinary work the staff of PDS has done in service to our clients. I would like to thank this subcommittee and the chairman for your time and attention to these matters and for your support of our work in the past.

PREPARED STATEMENT

I would be happy to answer any questions the subcommittee may have. Thank you.

Senator DURBIN. Thank you.

[The statement follows:]

PREPARED STATEMENT OF AVIS E. BUCHANAN

Good afternoon Mr. Chairman and members of the Subcommittee. My name is Avis E. Buchanan, and I am the Director of the Public Defender Service for the District of Columbia (PDS). I come before you today to provide testimony in support of PDS's fiscal year 2008 budget request. We thank Subcommittee members for their support of our programs in previous years.

With fiscal year 2006, the Public Defender Service added another year of providing excellent defense representation to people in the District of Columbia. Since

1970, when PDS was established as a model public defender serving in the newly created District of Columbia Superior Court, PDS has developed and maintained a reputation as the best public defender office in the country—local or federal. PDS has become the national standard bearer and the benchmark by which other public defense organizations often measure themselves in a number of practice and administrative areas.

In fiscal year 2008, PDS plans to work with the District of Columbia Court of Appeals to reduce the court's backlog of criminal appeals, continue to support PDS's human capital improvement plans, and continue to better assess its baseline costs.

PDS's fiscal year 2008 budget request supports PDS's human capital improvement plans by seeking a budget that keeps pace with inflationary increases and yet allows for PDS to build modestly on its human capital plans. PDS requests $32,710,000, a "flat" budget as compared with the President's fiscal year 2007 request,[1] to permit the office to maintain fiscal year 2007 salary levels and most costs associated with inflation. PDS's fiscal year 2006 budget was slightly lower than the level of the President's fiscal year 2005 budget request; with this essentially "flat" fiscal year 2006 budget, PDS focused on increasing and improving its internal efficiencies and maintained stable staffing levels.

BACKGROUND

In 1997, Congress enacted the National Capital Revitalization and Self-Government Improvement Act of 1997 (the Revitalization Act),[2] which relieved the District of Columbia of certain "state-level" financial responsibilities and restructured a number of criminal justice functions, including representation for indigent individuals. The Revitalization Act instituted a process by which PDS submitted its budget to Congress and received its appropriation as an administrative transfer of federal funds through the Court Services and Offender Supervision Agency (CSOSA) appropriation. The President's fiscal year 2008 budget requests that PDS receive a direct appropriation from the Congress. In accordance with its enabling act, PDS remains a fully independent organization and does not fall under the administrative, program, or budget authority of CSOSA. Rather, due to the constitutional mandate it serves, PDS necessarily maintains a separate and distinct mission from the missions of CSOSA and the Executive Branch.

In the District of Columbia, PDS and the local District of Columbia courts share the responsibility for providing constitutionally mandated defense representation to people who cannot pay for their own attorney. Under the District of Columbia's Criminal Justice Act (CJA),[3] the District of Columbia courts appoint PDS generally to the more serious, complex, resource-intensive, and time-consuming criminal cases. The courts assign the remaining, less serious cases and most of the misdemeanor and traffic cases to a panel of approximately 350 pre-screened private attorneys ("CJA attorneys").[4] Approximately 110 PDS staff lawyers are appointed to represent: the majority of people facing the most serious felony charges; a substantial number of individuals litigating criminal appeals; a significant number of the children facing serious delinquency charges; nearly 100 percent of people facing parole revocation; and the majority of people in the mental health system who are facing involuntary civil commitment.

While much of our work is devoted to ensuring that no person is ever wrongfully convicted of a crime, we also provide legal representation to recovering substance abusers participating in the highly successful Drug Court treatment program, and to children in the delinquency system who have learning disabilities and require special educational accommodations under the Individuals with Disabilities in Education Act.[5]

The Public Defender Service, unique among local public defender offices in that it is federally funded, has always been committed to its mission of providing and promoting constitutionally mandated legal representation to adults and children facing a loss of liberty in the District of Columbia who cannot afford a lawyer, and PDS has had numerous significant accomplishments in pursuit of that mission. In addition, PDS has developed innovative approaches to representation, from instituting measures to address the problems of incarcerated clients who are returning

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[1] The President's fiscal year 2007 budget request would have provided $32,710,000 for PDS. In February 2007, Congress funded PDS for the remainder of fiscal year 2007 at the level of $30,898,000, plus 50 percent of the Cost of Living Allowance, for an effective fiscal year 2007 budget of $31,103,000.

[2] Pub. L. No. 105–33, Title X (1997).

[3] D.C. Code §11–2601 et seq. (2001 Ed).

[4] An additional 75 CJA attorneys handle juvenile matters.

[5] 20 U.S.C. § 1400, et seq.

to the community to creating a one-of-a-kind electronic case tracking system. Other public defender offices across the country have sought counsel from PDS as they have patterned their approach to their work after ours.

As part of its statutory mission to promote quality criminal defense representation in the District of Columbia as a whole, PDS continues to provide training for other District of Columbia defense attorneys and investigators who represent those who cannot afford an attorney, and to provide support to the District of Columbia courts.

FISCAL YEAR 2008 REQUEST

The Public Defender Service's fiscal year 2008 budget request is for funding at the same level as that contained in the President's fiscal year 2007 request, or $32,710,000. PDS's actual apportionment under the full year fiscal year 2007 Continuing Resolution is five percent lower at $31,103,000. PDS's fiscal year 2008 request requires that PDS absorb normal and customary business cost increases and new costs not previously identified as part of base level funding. This will be the second time within four years that PDS has requested to manage to an essentially flat budget: in fiscal year 2006, PDS proposed retaining a budget level of $29,535,000 that was slightly lower than the fiscal year 2005 enacted level of $29,594,000, net of rescissions. While managing in fiscal year 2008 to a budget level that is flat with the President's fiscal year 2007 budget will present a challenge for PDS, PDS believes it can accomplish this without adversely impacting the constitutionally mandated legal services it provides to individuals in the District of Columbia.

PDS'S IMMEDIATE NEEDS

PDS faces two major challenges over the next several years that require planning and flexibility:

—*Escalating Baseline Costs*.—PDS has been assessing and evaluating the true cost of its base funding since the passage of the Revitalization Act. In fiscal year 2008, PDS will have to absorb several items beyond its control that have not been previously included in PDS's base. For example, it has been determined that, starting in fiscal year 2008, as a federally funded entity, PDS must comply with the Federal Employees' Compensation Act (FECA).[6] The law requires that the Department of Labor (DOL) submit a bill to each federal entity for the program liability that will occur in future years. PDS has received notice from DOL that PDS's FECA liability payment for fiscal year 2008 will be $130,000. Another cost beyond PDS's control is the cost of transcription services. Recordings must be reduced to transcripts for use in court proceedings. As law enforcement and the government rely increasingly on digitally recorded evidence, PDS's transcription costs will soar. PDS saw the first indications of this change in a recent case in which the transcription costs were $15,000. This change is estimated to increase PDS's transcription costs by $100,000 annually by fiscal year 2008. A final example is the cost of mileage reimbursements. PDS is constitutionally required to investigate cases and meet with clients. Pre-trial case work requires investigators to travel many miles around the D.C. metropolitan area locating and speaking with witnesses, and meeting clients often requires trips to prison facilities throughout the mid-Atlantic region. The rate of reimbursement for mileage is not within PDS's control and is likely to be substantially higher in fiscal year 2008 than the current rate.

—*Appellate Workload*.—PDS is under unusual pressure from the District of Columbia Court of Appeals to expand its Appellate Division staff to help the Court meet its performance goal of reducing the time required to resolve cases. PDS has responded by hiring three new appellate attorneys (two of whom will be brought on board toward the end of this fiscal year), but is constrained by space limitations to respond further. This solution cannot be sustained over the long term, and PDS has no reasonable expectation that this workload pressure will abate.

Despite these challenges, PDS believes it can manage to a restricted budget in fiscal year 2008. PDS plans to manage hire lag so that vacancies will not jeopardize client representation, but will generate savings in salary to help offset the usual labor cost increases expected in fiscal year 2008 and the increases in non-discretionary fixed costs (e.g., rent, litigation costs). By incorporating a longer hiring lag, by keeping about 10 positions unfilled, and by controlling costs, PDS will manage to the requested $32,710,000 that matches the fiscal year 2007 budget request.

[6] 5 U.S.C. § 8147 (1993).

Any reduction in funds from the President's fiscal year 2008 budget request for PDS however, will directly impact services. PDS's budget line items are fixed, with little flexibility on the part of PDS to decrease spending. In PDS's fiscal year 2008 budget request, 77 percent is allocated to personnel and related benefit costs ($25,295,000 out of $32,710,000). Of the $7,415,000 budgeted for non-personnel budget costs, approximately 95 percent consists of fixed costs (e.g., rent, utilities, payroll and financial services, equipment maintenance and licensing, litigation costs). PDS has no capital expenditures and spends relatively little on training and conferences, outside travel, and library materials. Reductions in litigation expenditures impact the quality of the representation provided. Reductions in the already small non-lawyer professional staff impact PDS's ability to manage the organization efficiently and effectively. PDS cannot, as many agencies can, detail individuals from other divisions to fill the gap. Reductions in front line staff (e.g., lawyers, investigators) lower the number of cases PDS can manage and simply shift the burden for supplying these constitutionally mandated services to the court's Criminal Justice Act budget. Of the approximately 110 lawyers at PDS, only six do not handle any individual cases. All supervisors, most division chiefs, and even some of the executive staff handle cases along with their supervisory and administrative responsibilities.

As detailed below in the accomplishments section, PDS plays a critical role in ensuring that all persons in the District of Columbia criminal courts receive due process. Failure to provide this fundamental right undermines the public's confidence in the criminal justice system and leads to wrongful convictions. While PDS's budget is a fraction of the cost of the entire criminal justice system in the District of Columbia, the high quality of PDS's performance is recognized by all the participants in the criminal justice system. The District of Columbia Court of Appeals and the Superior Court for the District of Columbia not only recognize this performance;[7] they rely on it in countless serious cases. Diminishing PDS's capacity to provide representation to those who cannot afford counsel would diminish justice in the District of Columbia.

FISCAL YEAR 2006 ACCOMPLISHMENTS

As in previous years, PDS devoted substantial resources toward the majority of the most serious cases filed in the Superior Court's Criminal Division. In fiscal year 2006, PDS was assigned to 77 percent of the Felony One cases and to 65 percent of the Accelerated Felony Trial Court (AFTC) cases. Felony One cases include all homicides, and AFTC cases include all while-armed offenses that carry potential life sentences and are to be tried within 100 days. In another of PDS's key practice areas, mental health matters, PDS was appointed to 63 percent of the involuntary commitment cases filed in the District of Columbia.

As part of its long-term human capital strategy, PDS has engaged the services of a consultant to assist in evaluating PDS's compensation and performance evaluation practices with the goal of maintaining the current culture of excellence and collaboration while updating and expanding the options available to PDS managers and improving the link between compensation and individual performance. Pursuant to this process, PDS laid the groundwork for adopting an improved salary scale for all PDS employees. Also, PDS has successfully transitioned to working with a new payroll service provider. The conversion has vastly improved record keeping. In addition, PDS has conducted two first-ever surveys—one survey of clients and one of CJA attorneys—in support of PDS's strategic plan and annual performance plan.

GENERAL PROGRAM ACCOMPLISHMENTS

Collaborative Work

While well-respected and widely known for zealously advocating on behalf of clients in the criminal justice system's adversarial process, PDS also works closely with criminal justice agencies and the courts to make the criminal justice system function more efficiently and fairly.

Collaborative work, essential to an efficient and fair criminal justice system, can pose obstacles to a legal entity such as PDS because PDS must always be mindful of its professional obligation to individual clients. PDS cannot waive any current or future client's right to assert a particular position or challenge a procedure. This can be frustrating to criminal justice agencies that are not similarly constrained. In addition, PDS's collaboration is often with traditional adversaries that view PDS with

[7] Just recently, a senior judge on the D.C. Court of Appeals commented at the close of an oral argument that a junior PDS attorney's rebuttal argument was the best that the senior judge had ever heard.

suspicion. Nonetheless, PDS continues to collaborate, producing both large and small changes that improve the criminal justice system.

"Safe Surrender" Warrant Resolution Program.—During the past fiscal year, PDS has worked with a number of District of Columbia criminal justice agencies, both local and federal, to plan for the institution of the "Safe Surrender" program—a program that encourages individuals with outstanding arrest warrants and bench warrants to turn themselves in exchange for favorable consideration by the court. Initiated by the U.S. Marshals Service in Ohio to minimize the danger to law enforcement officers of locating and arresting these individuals, the program limits participation to those with less serious charges. The program collaborates with the faith-based community by obtaining the permission of a local church to use its facility as the site for implementation.

Health Care Decisions for People with Mental Retardation or Mental Illness.—In fiscal year 2006, PDS led an effort to bring together the D.C. Council, the Office of the Mayor, the Office of the Attorney General, and a number of non-governmental organizations to improve the District's approach to substituted decision-making on behalf of persons without family support who lack the capacity to make their own health care decisions. PDS has represented many clients in the criminal justice system, in the juvenile delinquency system, and in the mental health system who were incapable of making medical decisions and who had no family. As a result, PDS has developed some expertise securing medical treatment for these disadvantaged clients. The District's law, which, for years, had been passed repeatedly on an emergency basis, permitted the District to make health care decisions for individuals with mental retardation, without regard to the individual's capacity to make those decisions. The District had proposed creation of a complicated and resource-intensive process that required the development of a panel to determine the capacity of a person with mental retardation to make urgent health care decisions and then to decide on behalf of anyone found incapacitated, whether or not to consent to the urgent medical procedure.[8] Based on the experiences of PDS lawyers working on behalf of clients with mental retardation and clients with mental illnesses, PDS knew this approach would be unwieldy and would compromise the health and the decision-making rights of PDS's clients. PDS proposed, and the group adopted, legislation modifying the Health-Care Decisions Act, the laws governing the provision of services to people with mental retardation, and the guardianship laws to create an expedited process for the courts to appoint a temporary and limited guardian to address medical decisions in appropriate cases where a person has been deemed incapacitated under the Health-Care Decisions Act. Enactment of this legislation on a temporary basis late last fall has streamlined and improved the decision-making in urgent and routine medical treatment for some of the District's most vulnerable residents.

Other Program Accomplishments

PDS engaged in a number of activities during the past fiscal year that had significant implications for individual clients or that improved the overall administration of justice.

Individual Clients

The core work of PDS is the representation of individual clients facing a loss of liberty. The criminal justice system is premised on an adversarial system, and PDS has able adversaries in the District's Attorney General's Office and the United States Attorney's Office for the District of Columbia. A fair criminal justice system depends on having all components (judges, government, and defense) fulfill their respective roles. PDS plays a pivotal part in ensuring that all cases, whether they result in pleas or trials, involve comprehensive investigation and thorough consultation with the client, and that the trials constitute a full and fair airing of reliable evidence. As it has every year since its inception, PDS won many trials in fiscal year 2006, fought a forceful fight in others, and found resolution prior to trial for many clients. Whatever the outcome, PDS's goal and achievement for each client was competent, quality representation.

All of these cases and their outcomes are far too varied and numerous to recount here, and the ethical rules that protect all clients' confidences, regardless of their economic circumstances, preclude PDS from providing detailed examples. Instead, the following cases, absent identifying information, are a small sample of how competent, quality representation can change lives.

Unlawful Detention.—In a case of mistaken identity, PDS obtained the release of a man who was unlawfully held at the D.C. Jail for two weeks for an offense he

[8] Emergency medical situations already have streamlined procedures in place.

did not commit. The Community Defender Division (CDD) intervened to convince officials at the D.C. Jail and at the U.S. Marshals Service to release the client. The client had been detained by Maryland police authorities during a routine traffic stop. The police conducted a computer records check which revealed that a warrant had been issued in the District for someone with the same name as the client who had reportedly escaped from a halfway house in 2004. The client was arrested in Maryland and shortly thereafter was transported by the U.S. Marshals Service to the D.C. Jail, where he waited to be returned to the custody of the Bureau of Prisons because of his alleged abscondance from Hope Village.

The client explained to the police, to the U.S. Marshals Service, and, eventually, to D.C. Jail officials that although he had served time in a Federal Bureau of Prisons facility, he had never been placed in a halfway house before, and he insisted that he had not been re-arrested since his release in 2005. Furthermore, the client told officials that someone had earlier stolen his ID card and that he had been the subject of a case of mistaken identity in the past. Even after the face of the person who had actually absconded from the halfway house appeared on the D.C. Department of Corrections computer database, D.C. Jail staff simply exchanged the client's picture with the one already in the database, effectively placing a charge on his record that he did not commit.

The client's mother complained to PDS's CDD staff, frustrated because for two weeks, she had been trying to convince D.C. Jail officials that they were holding the wrong man. CDD staff interviewed the client at the jail and performed a records search. CDD staff determined that the client could not have been the person who had absconded in 2004 because the client had been serving his Federal Bureau of Prisons sentence at the time; the client was released from the D.C. Jail within 24 hours of when CDD staff began investigating the matter.

Elderly Veteran.—A 70-year-old veteran was charged with losing contact with his parole officer and faced a parole revocation hearing as a result. The client, who has no family, is partially blind and partially deaf, has severe and numerous disabling medical conditions, and cannot walk unassisted. During one of his hospital stays, his rooming house was sold. When he was released, he had no place to stay and would sleep wherever he could. Homeless and ailing, he stopped going to meet with his parole officer who then issued a parole violation warrant for the client's arrest. He was held at the D.C. Jail pending his parole revocation hearing. Before his hearing, his PDS attorney and program developer collected volumes of medical records from the Veterans Administration, made appropriate referrals, and set up services that would allow him to function independently in the community. PDS even arranged for transportation to his new residence in the event that the U.S. Parole Commission decided to release him. After his hearing, not only was the client released, his case was closed—implicit acknowledgment that the client's and the community's interests were better served by the services PDS arranged than by those that the U.S. Parole Commission could provide.

Disabled Children.—A trial attorney's newly arrested 13-year-old client did not know his mother's phone number (or the phone number for any relative whatsoever), or even how to spell his mother's name. He could not give any contact information to the police or to the court besides an address. The client's mother had only a cell phone, and no home phone. On the morning of the client's first appearance in juvenile court, the trial attorney called another PDS trial attorney at home to ask her if she could think of a way to get in touch with the client's mother. The second attorney volunteered to drive to the mother's house and see if she was home, and to bring her down to court if she was.

The initial (release) hearing started, and the court's Social Services department and the prosecutor both recommended placing the client in secure detention, in part because of the lack of information about the client's social history and the fact that no parent was present. The client was crying and asking his attorney where his mother was. The court refused the trial attorney's request for a very short delay to allow her to find the client's mother. Because of the client's age, the court was disbelieving when the trial attorney explained that the client did not know his mother's phone number. During the hearing, the client's mother entered the courtroom. She had been worried all night because she had no idea where he was. She had been about to call the police when the second PDS trial attorney came to the house looking for her. The mother was able to explain to the court that her son is severely limited mentally and that he had trouble remembering her phone number despite her repeated efforts to teach him. The court released the client to his mother.

Discovery Litigation.—Over the past fiscal year, PDS lawyers have continued to monitor the government's compliance with its obligations to disclose *Brady*[9] evidence—evidence that is favorable for or tends to exculpate the client. What constitutes *Brady* evidence and when that evidence must be disclosed to the defense are strenuously disputed issues in Superior Court. PDS is at the forefront of this litigation, which has produced success at the appellate court level and a number of acquittals and dismissals at the trial court level. PDS has filed dozens of pleadings in trial cases over the past year and was asked to file a "friend of the court" brief in an appellate case addressing *Brady* and the government's conduct in a specific case. The appellate decision resulted in further trial court proceedings concerning what exactly was suppressed by the government and whether its suppression affected the outcome of the trial; other trial level litigation has resulted in a number of acquittals and, on occasion, determinations by the government that the charges should be dismissed.

Appellate Division

The Appellate Division's appellate litigation has an impact throughout the District's criminal justice system as decisions in its cases often establish or clarify the standards trial court judges and litigants must follow in criminal and juvenile cases. The complex and novel legal issues the Division is called upon to address are handled by its experienced and talented attorneys.

Changing the Law.—In fiscal year 2006, in *Wilson-Bey* v. *United States*, the D.C. Court of Appeals issued a landmark unanimous en banc (full court) decision changing the standard for accomplice liability in the District of Columbia and bringing it in line with the standard used in the federal courts and most states. In the District of Columbia, since the late 1970s, the Court's decisions have approved jury instructions stating that an accomplice is legally responsible for the "natural and probable consequences" of the crime in which he intentionally participates. Since the early 1980s, PDS has argued in several cases that the Constitution requires that the government should have to prove the same intent element for an offense whether a defendant is charged as a principal or an accomplice. As PDS has argued, it is precisely when the defendant is merely an accomplice and did not commit the crime that the intent requirement becomes all the more important under traditional norms of criminal liability. In *Wilson-Bey*, PDS made this same argument as amicus curiae (friend of the court). The Court agreed with PDS and, in a scholarly 50-page opinion, unanimously held that the natural and probable consequences language erroneously omits the intent element of the offense charged, that the error is of constitutional magnitude, and that the government must prove all the elements of the offense, including premeditation, deliberation, and intent.

Enforcing Constitutional Protections.—PDS recently argued successfully to the D.C. Court of Appeals in an amicus curiae (friend of the court) brief that there is no "expert witness" exception to the Confrontation Clause. In December 2006, the Court in *Thomas* v. *United States*[10] held that a Drug Enforcement Agency (DEA) chemist's certified hearsay report is a paradigmatic "testimonial" document that clearly falls within the protections of the Sixth Amendment Confrontation Clause under the Supreme Court's watershed decisions in *Crawford* v. *Washington*[11] and *Davis* v. *Washington*.[12] In a lengthy and meticulously reasoned opinion, the Court traced the right of confrontation to its common-law roots and to the Framers' disdain for "trial by affidavit," the "primary evil" targeted by the Confrontation Clause. Given that the DEA chemist's certificate is an affidavit-like document produced in anticipation of its use in a criminal trial and is relied upon by the government to prove an essential element of the offense, the Court "agree[d] with [PDS] that 'it is difficult to imagine a statement more clearly testimonial.'" The Court also held that a defendant's ability to subpoena the chemist and call him as a hostile witness in the defense case does not satisfy the Confrontation Clause under *Crawford*. The Court again relied on PDS's brief, reasoning that, "[i]f the defendant exercises his constitutional right to put the government to its proof and not put on a defense, the prosecution evidence—what [PDS] aptly calls 'the misleadingly pristine testimonial hearsay of absent witnesses'"—may appear deceptively probative in the absence of cross-examination. Across the country, courts are considering the admissibility of various "expert reports" without live testimony. The *Thomas* opinion will undoubt-

[9] *Brady* v. *Maryland*, 373 U.S. 83 (1963).
[10] *Thomas* v. *United States*, 914 A. 2d 1 (2006).
[11] *Crawford* v. *Washington*, 541 U.S. 36 (2004).
[12] *Davis* v. *Washington*, 126 S. Ct. 2266 (2006).

edly be highly influential, both because it so thoroughly addresses the issue and because the Court is so well-regarded nationally.

Protecting Society's Interest in a Fair Trial.—In *United States* v. *Mickens*, PDS secured a remand from the D.C. Court of Appeals after a trial judge failed to interview a juror who sent a note during deliberations stating that the deliberations had deteriorated and that, as a result, he was unable to render a fair verdict. The Court of Appeals remanded the record to the trial judge so that he could do what he should have done before the verdict was taken and speak with the juror. At a hearing, the juror told the trial judge that the guilty verdict had been forced. The juror said he had agreed to a guilty verdict only because the foreperson had threatened him with physical violence and because the trial judge had ignored his pleas for help. In the end, the government dismissed the criminal charges, and PDS righted an injustice the juror had himself attempted to right some two years earlier.

Protecting the Constitutional Right to Present a Defense.—The Appellate Division convinced the D.C. Court of Appeals that the trial court was wrong for refusing to admit testimony of a defense witness about an excited utterance made by the client. The client, after shooting a would-be robber in self defense, ran to his friend's house, "shaking," "hysterical," "scared," and "terrified." He told his friend that someone had tried to rob him. The trial court ruled that the friend couldn't testify about this statement because, as the defendant's friend, he was too interested in the case.

The Court of Appeals held that the trial court was wrong in declaring the friend unreliable and barring him from testifying, ruling that the trial court made it impossible for the defense to present evidence related to the client's actions in response to the attack. The Court held that the client was thus prevented from presenting evidence crucial to his case, reversed the decision, and remanded the case to the trial court.

Special Litigation Division

The Special Litigation Division litigates systemic issues in the District of Columbia criminal justice system before every court in the District of Columbia—the Superior Court and Court of Appeals in the local system, and the District Court, the Court of Appeals, and the Supreme Court in the federal system. These are some of the highlights of SLD's fiscal year 2006 litigation:

Incarcerated Young Adults.—In *J.C., et al.* v. *Vance, et al.*, the Special Litigation Division seeks to compel the District of Columbia to provide special education services to eligible youth incarcerated in the D.C. Jail and the Central Treatment Facility (CTF). A final settlement agreement was filed in federal district court at the beginning of the year. This settlement was effectively a total victory for plaintiffs—the District agreed to bring its special education program into compliance with federal law. The first phase of the settlement, which called for the District to draft a set of policies and procedures addressing all aspects of the program (including program funding, infrastructure, staffing, curriculum, student screening and evaluation, and interagency collaboration) is now complete, and the parties have moved on to the implementation phase of the program. The District has a year to fully implement its special education program at the D.C. Jail and CTF. PDS is monitoring the District's efforts to ensure that it honors its commitments.

Incarcerated Children.—PDS has litigated the lawsuit challenging the juvenile detention system in the District, *Jerry M., et al.* v. *District of Columbia, et al.*, for 21 years, and a resolution of the case continues to appear possible. The lawsuit and the resulting consent decree focus on the conditions of the juvenile detention facilities and on the treatment and rehabilitation provided to youths at the facilities to reduce their chances of re-offending and to increase their chances of becoming productive members of the community. Three years ago, PDS's Special Litigation Division asked the court to appoint a receiver to oversee the District's Youth Services Administration (now the Department of Youth Rehabilitation Services (DYRS)) until the consent decree's mandates could be met. While the request was pending, the parties agreed to the appointment of a Special Arbiter in lieu of a receiver to bring the District into compliance by assisting the parties in creating a work plan to implement the consent decree. SLD and the District are now well on their way toward implementing a comprehensive work plan to address the systemic issues that have plagued the District's juvenile justice system for years. In the last two years since the Special Arbiter was appointed, the lawsuit has led to:

—*New Oak Hill Youth Center*.—Plaintiffs and defendants worked with the D.C. Council to introduce legislation that resulted in an emergency bill to fast-track construction of the new facility. Plaintiffs and DYRS are continuing to work with the architects, who are national experts in the construction of juvenile facilities, in addition to consultants from Missouri (see below), and it appears that the facility that will replace the current youth secure detention facility will not

only be a great improvement, but may be the premier juvenile facility in the nation. It is set to open in April 2008.

—*Missouri Youth Services Institute*.—Plaintiffs and the Special Arbiter have worked with DYRS to hire consultants from the Missouri Youth Services Institute (MYSI) to implement reform at Oak Hill even before the new facility opens by equipping its staff with the training and tools to function daily as counselors, as opposed to correctional officers, and to operate well-run treatment programs. MYSI is comprised of former staffers who led what is widely regarded as the nation's model juvenile institutional reform effort in Missouri. DYRS has now opened four "Missouri-style" units at Oak Hill, and the physical plant and the services for youth at Oak Hill have dramatically improved. Through work with the court, the Office of the Attorney General, and the MYSI staff, DYRS has now successfully reduced the detained and committed populations such that there are only approximately 70 youth at Oak Hill (down from 260 in December 2004), all of whom are committed. The approximately 80 detained youth are all currently housed at the YSC (see below).

—*Youth Services Center*.—Plaintiffs and the Special Arbiter also secured the hiring of Earl Dunlap, founder and former Executive Director of the National Juvenile Detention Association (NJDA), to work with staff at the Youth Services Center to improve safety, security, and operations. Mr. Dunlap and staff from NJDA are playing a vital role in the efforts to equip YSC staff with the skill set necessary to operate a safe and humane juvenile detention center.

—*Evening Reporting Centers*.—Plaintiffs have worked with DYRS to open Evening Reporting Centers (ERCs) as alternatives to detention, which has resulted in significantly reducing the population of detained children. DYRS currently has two ERCs in operation, one located in Ward 4 (serving youth from Wards 1, 2, and 4) and one in Ward 8 (serving youth from Wards 6, 7, and 8). ERCs are a very intensive form of community placement, providing six hours of daily, face-to-face supervision by adults for the youths ordered into the facilities.

—*Expert Services*.—Plaintiffs and the Special Arbiter have worked this past year on improving the quality-of-life and safety issues at the facilities, and have worked with top experts to prepare baseline reports on issues such as fire safety, housekeeping, key control, and mental health. These have turned into corrective action plans that have been filed with the court and have been models for implementing serious reforms at the institution. The parties are now awaiting the final baseline report for medical services.

—*Educational Initiatives*.—With help from the plaintiffs and the Special Arbiter, DYRS successfully led a campaign to establish an alternative education model to replace the traditional one provided by D.C. Public Schools (DCPS). The Special Arbiter helped facilitate communications between DYRS and DCPS that helped produce an agreement for the replacement of the DCPS model. The new model is designed specifically for youth in secure custody and will include innovative and proven delivery models by providers with knowledge and experience in working with at-risk youth in the juvenile justice system. RFPs are currently being reviewed, and a charter school will be taking over the Oak Hill school in the fall of 2007.

Community Defender Division

The Community Defender Division assists children and adults who are confined in correctional facilities or who are returning to their communities after periods of incarceration.

Expungement Summit.—In fiscal year 2006, PDS brought together 21 service providers for its second Expungement Summit.[13] Modeled after a successful program in Chicago, the Summit offered assistance to individuals with criminal records, determining whether the individuals might be successful in seeking to seal their arrest records and providing them with social services resources. Over 600 individuals participated, receiving assistance with job searches; interview skills; referrals for re-

[13] The service providers included Job Corps (Dept. of Labor); Jobs Partnership of Greater Washington; A-Men (Anacostia Men's Employment Network); Housing Counseling Services; EXCEL Institute; Neighborhood Legal Services Program (D.C.); D.C. Employment Justice Center; Washington Legal Clinic for the Homeless; the Better Way Program (Pilgrim Rest Baptist Church); Concerned Citizens on Alcohol and Drug Abuse (CCADA); D.C. Department of Employment Services (DOES) (Mobile Van); Samaritan Inns Intensive Recovery Program; D.C. Central Kitchen/Training Program; Healthy Babies Project (Mobile Van); D.C. Chartered Health Plan; Opportunities Industrialization Center for D.C.; Efforts; Court Services and Offender Supervision Agency; YouthBuild PCS; D.C. Prisoners Legal Services Project, Inc.; the Children's Law Center; D.C. Law Students in Court; and the University of the District of Columbia David A. Clarke School of Law.

entry assistance, including the Work Opportunity Tax Credit; the Federal Bonding Program; disability benefits; public housing opportunities; and substance abuse treatment referrals. PDS not only collaborated with service providers, but also coordinated with the D.C. Council to create space at the Summit for the D.C. Council to hold a community-based hearing on proposed expungement legislation at the same location and same time as the Summit. PDS will continue to lead this collaborative effort to promote housing, gainful employment, and sound health care for ex-offenders returning to the District of Columbia.

Re-entry Programs.—In fiscal year 2006, the Community Re-entry Program sponsored a day-long conference, "Representing Combat Veterans in the Criminal Justice System," on providing assistance to veterans. The conference, which placed a special emphasis on veterans of the U.S.-Iraq war who are charged with criminal offenses, focused on the defenses and sentencing options available to them, and on the resources that are available for the health, employment, and education problems most encountered by veterans.

Parole Division

The Parole Division provides required representation to parolees facing revocation before the United States Parole Commission.[14] This Division represents nearly 100 percent of the D.C. Code offenders facing parole revocation. Consistent with that, in fiscal year 2006, PDS handled over 95 percent of parole and supervised release revocations.

Working with the U.S. Justice Department.—PDS's Parole Division continues to seek out areas of collaboration that will benefit individuals facing parole revocation. Most recently, PDS and the U.S. Department of Justice agreed to engage in ongoing discussions regarding revisions to the statute that governs proceedings before the U.S. Parole Commission. Because of the elimination of parole in the federal system, an increasing majority of the Commission's work consists of local District of Columbia matters as the number of federal parolees declines steadily. PDS's goal is to ensure that a new statute sets forth a fair and constitutional process for resolving matters before the Commission.

Training

PDS conducts and participates in numerous training programs throughout the year. The annual Criminal Practice Institute and the Summer Criminal Defender Training Program address the training needs of the court-appointed CJA attorneys and investigators. In fiscal year 2006, PDS attorneys and investigators also taught sessions at many D.C. law schools and other institutions. PDS attorneys were also invited to teach elsewhere locally, including at the D.C. Bar, the National Legal Aid and Defender Association, and at D.C. law firms offering pro bono services in Superior Court cases.

Visiting Chinese Lawyers.—PDS agreed to develop a modified version of its intensive training program for new PDS attorneys and of the accompanying training materials for lawyers visiting PDS from China. For two weeks, PDS provided these attorneys, working through translators, with lectures on criminal defense practice in the United States and with opportunities to participate in practical exercises in PDS's moot courtroom.

Forensic Science Conference.—In the face of growing evidence that most wrongful convictions are based on erroneous eyewitness identifications, PDS's 2006 Forensic Science Conference, the fourth such conference, brought the latest social science research and experts in the field to Washington, D.C. The conference provided defense attorneys with the information and tools necessary to properly investigate cases, to guard against erroneous identifications, and to educate jurors and judges about pitfalls surrounding eyewitness identification procedures currently in use by many law enforcement agencies.

Administrative Accomplishments

Relying more extensively on technology, PDS continues to strive to be a model public defender in its administrative operations as it is in its client representation. PDS has created greater links between its payroll and finance operations, and has responded to emphasis from Congress on continuity of operations plans and telecommuting by exploring ways of supporting employees away from their offices. PDS has invested in new technology in the form of both hardware and software that allow key staff to have secure access to electronic files and databases from remote locations. Also, in its ongoing efforts to adopt federal best practices, PDS continues to

[14] The Revitalization Act shifted responsibility for D.C. parole matters from the D.C. Board of Parole to the United States Parole Commission. 28 C.F.R. 2.214(b)(1) and 2.216(f).

incorporate the principles of the Government Performance and Results Act in the management of the office.

Continuity of Operations.—PDS has upgraded its continuity of operations plan to make it more comprehensive and to incorporate the capacity (e.g., Blackberrys and docking stations) PDS has provided to staff to obtain remote access to their case files and to relevant databases. Currently, key managers have access to electronic files and databases from remote locations, and all staff have remote access to electronic mail. PDS will continue to develop the ability to support the technology that provides flexibility in work location and work schedule for all key staff. PDS is also tracking the continuity of operations plans of the various criminal justice agencies that would have to collaborate in the event of a disruption to the criminal justice system as a whole.

Government Performance and Results Act.—Consistent with its strategic plan and annual performance plan, PDS conducted its first-ever client survey and its first-ever survey of CJA attorneys. These surveys are two of several—judicial, PDS employee, social service provider, CJA attorney, and client—that PDS plans to conduct regularly to assess its performance. Our strategic plan calls for the judicial, CJA attorney, and client surveys to be conducted on a staggered triennial schedule.

The client survey was done on a pilot basis to test PDS's ability to locate and communicate with former clients, some of whom have moved and some of whom are incarcerated.[15] The survey consisted of twenty questions that focused on issues such as client perceptions of PDS's attentiveness to clients and preparedness for court. The majority of the clients who responded agreed with statements such as, "I felt my attorney was working hard for me," and "[M]y PDS attorney was prepared to represent me before the D.C. judicial system, and "[T]he PDS office staff treated me with respect and courtesy."

The eleven questions contained in the CJA bar survey related to the bar's assessment of PDS's effectiveness and to the quality and extent of PDS's support of the CJA attorneys. The survey responses reflected the value that the CJA bar places on the training PDS provides, and they identified areas where PDS can better serve those attorneys.

Over 90 percent of the responding CJA attorneys generally agreed that PDS achieves its mission of providing and promoting quality representation to clients, protecting society's interest in the fair administration of justice, and providing helpful and relevant training to CJA attorneys. The survey revealed a definite interest among CJA bar members in having PDS use its website or other communication methods more frequently to provide regular updates on recent changes in criminal law and procedure.

PDS's other performance measures include determining the rate at which clients are released pending their trial or hearing dates. Release is a goal of virtually every PDS client, and having a client in that status improves the staff's ability to prepare the case and represent the client overall. For fiscal year 2006, PDS had a target of having clients released in 65 percent of cases. PDS obtained clients' release in 62 percent of the cases.

In addition, PDS measures the rate at which attorneys have their first substantive visits with their clients after appointment. PDS's expectation is that an attorney will meet with a newly assigned client as soon as possible. Building trust is key to developing a good attorney-client relationship, and meeting with a client right away is a fundamental step toward establishing that trust and creating a positive impression. Early meetings also assist the attorney with investigation, as leads get "colder" with time. While certain legitimate circumstances may interfere with an attorney's ability to see a client as soon as is preferable (e.g., the attorney may be in trial), PDS has nonetheless set a two-day standard for this to occur. For fiscal year 2006, PDS had a target of having these initial meetings in 75 percent of the cases. PDS surpassed that target, achieving initial meetings within two days in 89 percent of the cases.

CONCLUSION

I would like to thank the members of the Subcommittee for your time and attention to these matters. I would be happy to answer any questions the Subcommittee members may have.

Senator DURBIN. Ms. Gist.

[15] The difficulty PDS anticipated in surveying this group was confirmed by the fact that more than 50 percent of the surveys were deemed undeliverable to the clients' last known addresses.

STATEMENT OF DEBORAH A. GIST, STATE EDUCATION OFFICER, GOVERNMENT OF THE DISTRICT OF COLUMBIA

Ms. GIST. Good afternoon, Mr. Chairman, subcommittee, staff and guests. I'm Deborah Gist and I serve as the State Education Officer in the District of Columbia. I appreciate this opportunity to testify today on the success of one of our most valued programs in the District of Columbia, the D.C. Tuition Assistance Grant Program, or D.C. TAG.

I'm here to present testimony in support of the President's fiscal year 2008 funding request and budget justifications for the D.C. TAG program. Let me say, for the record, how much Mayor Fenty and our community appreciate the past and continued support of the Senate Appropriations Committee and you, in particular, Mr. Chairman, for the D.C. TAG Program.

The D.C. Tuition Assistance Grant Program deserves to be funded for fiscal year 2008 at the mark established by the President for two reasons. Because the District of Columbia counts on the funding to provide affordable college options to its residents and most importantly because the program is working.

We are increasing the number of college going District residents. Simply put, the D.C. TAG Program levels the playing field by providing District residents with the same opportunities that high school graduates from around the country receive—the ability to pay for college at the in-State or near the in-State tuition rate.

In fiscal year 2006, the State Education Office provided an average TAG award of $6,393 to more than 4,800 students. In the District of Columbia, graduating seniors have a single option for public higher education, the University of the District of Columbia.

The university is a relatively young institution that celebrated its 30 year anniversary in 2006. While the university educates thousands of students every year, a single State school is not the solution for every student in the District of Columbia who wants to go to college.

In every State in the Nation students are able to choose from among multiple public universities and colleges on multiple campuses. For example, neighboring Maryland has 14 4 year public university campuses and 16 community colleges. State colleges and universities are well known for providing quality public education at an affordable price.

The D.C. Tuition Assistance Grant Program provides this choice for the students in the District of Columbia. By bridging the gap between the in-State and out-of-State tuition rates so that students can attend colleges and universities in other jurisdictions at affordable prices.

The TAG Program provides up to $10,000 per academic year, up to a lifetime maximum of $50,000 for District residents who have a high school diploma and start college by the age of 24. Additional options include up to $2,500 for community colleges, for historically black colleges, and universities—and for private universities in the D.C. metropolitan area.

In 1999, prior to the existence of the D.C. TAG Program, District residents paid an average $7,890 annually to attend an institution of higher education—compared to a much more favorable national rate of $3,215 annually.

As you well know Congress, therefore, passed the District of Columbia College Access Act and the D.C. TAG Program has received a great deal of bipartisan support since then. To date, including the current school year, the program has dispersed nearly $160 million to the benefit of over 11,000 District residents.

Since the inception of the D.C. TAG Program and the 2000/2001 school year, the number of District of Columbia public school students who go on to attend an institution of higher education has doubled. That's a phenomenal achievement for a program that's only in its seventh year.

Some characteristics of D.C. TAG Programs are as follows: 38 percent of D.C. TAG grantees are the first in their family to attend a college or university.

And I'll actually point out that this number has decreased because the more and more students that we're sending to college and their siblings are going as well, it used to be over 50 percent; 68 percent of awards are provided to students with very low or low income levels as defined by the estimated contributions families are expected to make to support their child's educational needs.

The District of Columbia, like other governments across the country, is focused on encouraging as many of its residents as possible to go to college. Recent research suggests that only 28 percent of jobs within the District of Columbia belong to District residents. This in large part is a result of the skills required to attain these jobs. In 2005, for example, 75 percent of new jobs created required at least some postsecondary education.

The D.C. Tuition Assistance Grant Program is a central component of the District's strategy to enhance college access and college degree attainment in the District of Columbia. As a result TAG is changing the way of life for an entire generation of District residents and I would like to ask this distinguished committee to fund the D.C. TAG Program for $35.1 million for fiscal year 2008.

PREPARED STATEMENT

I appreciate this opportunity and I look forward to answering your questions.

[The statement follows:]

PREPARED STATEMENT OF DEBORAH A. GIST

Good afternoon, Mr. Chairman, members of the Senate Subcommittee on Financial Services and General Government, Committee staff and guests. My name is Deborah Gist and I serve as the State Education Officer in the Executive Office of the Mayor for the District of Columbia. I appreciate the opportunity to testify today on the success of one of our most valued higher education programs in the District of Columbia, the D.C. Tuition Assistance Grant (D.C. TAG or TAG) program. I am here to present testimony in support of the President's fiscal year 2008 funding request and budget justification for the D.C. TAG program. Let me say for the record how much Mayor Fenty appreciates the past and continued support of the U.S. Senate and the Appropriations Committee for the D.C. TAG program.

The D.C. TAG program deserves to be funded for fiscal year 2008 at the mark established by the President for two reasons: because the District of Columbia counts on the funding to provide affordable college options to its residents, and because the program is working to enhance the number of college going District residents. Simply put, the D.C. TAG program levels the playing field by providing District residents with the same opportunity that high school graduates around the country receive, the ability to pay for college at or near the in-state tuition rate. In fiscal year 2006, the State Education Office provided an average TAG award of $6,393 to more than 4,800 students.

In the District of Columbia, graduating seniors have a single option for public higher education—the University of the District of Columbia. UDC is a relatively young institution that celebrated its 30th anniversary in 2006. While UDC has done an admirable job of educating thousands of students every year, a single state school is not the solution for every student in the District of Columbia who wants to go to college.

In every state in the nation, students have the option to attend multiple public universities and colleges on multiple campuses. For example, neighboring Maryland has 14 four-year public university campuses and 16 community colleges. State colleges and universities are well known for providing quality education at an affordable price. The D.C. Tuition Assistance Grant program provides greater opportunities for students in the District of Columbia to obtain a college education by bridging the gap between the in-state and out-of-state tuition rate so that students can attend colleges and universities in other jurisdictions at affordable prices. The TAG program provides up to $10,000 per academic year—up to a lifetime maximum of $50,000, for District residents who have a high school diploma and start college by the age of 24. Additional options include:

—Up to $2,500 per academic year to bridge the gap between in-state and out-of-state tuition at a community college;

—Up to $2,500 per academic year to attend a historically-black college or university anywhere in the nation; and

—Up to $2,500 per academic year to attend a private university in the Washington, DC metropolitan area.

In 1999, prior to the existence of the D.C. TAG program, District residents paid an average of $7,890 annually to attend an institution of higher education compared to a much more favorable national tuition average of $3,215 annually. As such, Congress passed the District of Columbia College Access Act (Public Law 106–98) at the urging of the District's Congressional Delegate Eleanor Holmes Norton. It is important to note that the D.C. TAG program has received a great deal of bipartisan support since its inception. To date, including the current school year, the program has disbursed nearly $160 million for the benefit of over 11,000 D.C. residents.

Since the inception of the D.C. TAG program in the 2000–2001 school year, the number of District of Columbia public school students that go on to attend an institution of higher education has doubled. That's a phenomenal achievement for a program that's only in its seventh year. The characteristics of TAG recipients are as follows:

—38 percent of D.C. TAG grantees are the first in their family to attend a college or university;

—67 percent of tuition awards are provided to District of Columbia public school students;

—79 percent of D.C. TAG students attend public colleges and universities upon receiving a tuition award;

—over 90 percent of awardees attend college full-time; and

—68 percent of awards are provided to students with very low or low income levels as defined by the estimated contribution families are expected to make to support their child's educational needs.

In an effort to increase the graduation rates of students receiving the tuition assistance grant, the State Education Office is actively communicating with partner colleges and universities to ensure that D.C. TAG grantees are receiving the appropriate retention and academic services needed to support our students as they work to earn a college degree.

Numbers alone, however, fail to tell the story of the D.C. TAG program's success. This is one of those occasions where our grantees or their families tell their own stories far better than I ever could. So I will share with you the words of Wezlynn Davis, whose daughter Niya graduated from North Carolina Central University last year. Ms. Davis writes,

"We, the Davis family, have been truly blessed by the District of Columbia Tuition Assistance Program. I don't know what we would have done without it. . . . I hope that the program continues in the future and the process won't change much because I have another youngster who will be attending college. He wants to be a culinary chef and has his mind set on it. . . . Thank you for all you and others are doing to make sure our black children succeed. It gives them self worth and a sense of pride knowing that they can afford to attend college. I know my daughter is happy. She graduated on May 6, 2006, the first . . . of my children to do that. I am ecstatic."

This is just one example of success as a result of the D.C. TAG program.

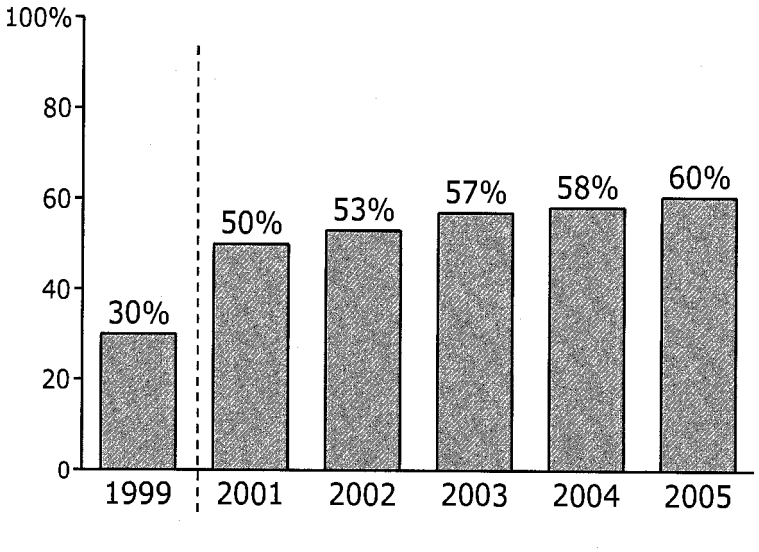
The Government of the District of Columbia, like other governments across the country, is focused on encouraging as many of its students as possible to go to college. Recent research suggests that only 28 percent of jobs in the District of Columbia belong to Washington, DC residents. This is in large part a result of the skills required to obtain these jobs.[1] In 2005 for example, 75 percent of the new jobs created in the District of Columbia required at least some post secondary education.[2] In addition, the Washington, DC metropolitan region has one of the highest college degree attainment rates in the country with over 42 percent of the region's residents having at least a bachelor's degree and 20 percent having graduate degrees.[3] The District's students have to be able to successfully compete for jobs in this highly educated environment. The D.C. Tuition Assistance Grant is a central component of the District's strategy to enhance college access and college degree attainment in the District of Columbia.

As a result of the Tuition Assistance Grant, the way of life is changing for an entire generation of young people, and I would like to call upon this distinguished committee to re-authorize D.C. TAG once again for fiscal year 2008 at the funding level requested by the President.

I appreciate the opportunity to testify today, and I look forward to answering your questions.

ATTACHMENT A

College enrollment of DCPS graduates has doubled since DC-TAG was launched



Note: Excludes alternative school graduates; enrollment after 12-months in college
Source: DC-CAP internal data; Fannie Mae study

[1] Fuller, Stephen S., Ph.D., *The District of Columbia Chamber of Commerce State of the Business Report 2006*, D.C. Chamber of Commerce, February 2006.

[2] Ibid.

[3] Greater Washington Initiative, Internet, http://www.greaterwashington.org/pdf/RR__2006.pdf, Accessed 29 March 2007, p. 12.

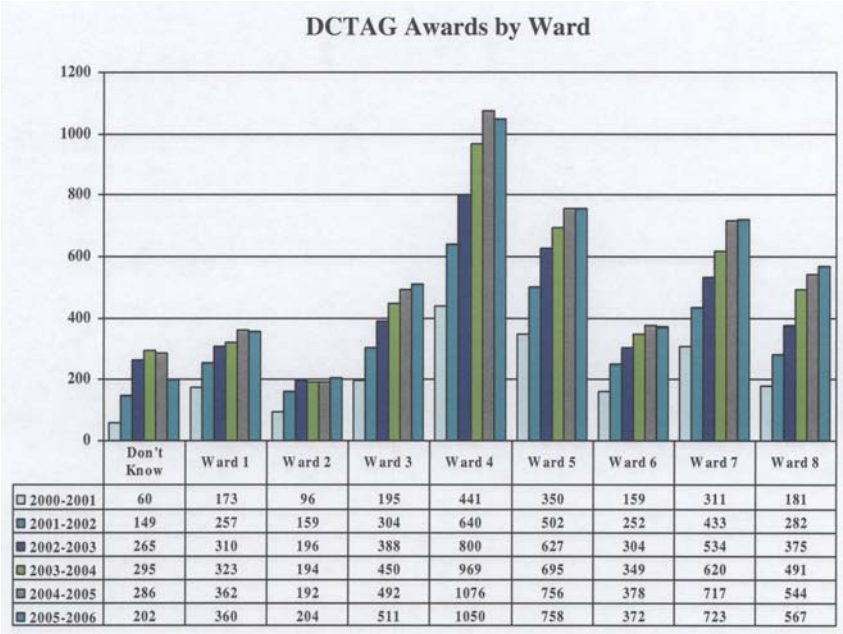
ATTACHMENT B.—NUMBER OF AWARD RECIPIENTS

State	2000–2001		2001–2002		2002–2003		2003–2004		2004–2005		2005–2006		Total	Increase 2000–06
	Public	Private	Public	Private	Public	Private	Public	Private	Public	Private	Public	Private		
Alabama	2		8	1	9	4	16	5	10	10	10	12	87	+20
Arkansas	1		2		2		2		2		1		10	
Arizona	7		15		16		17		20		16		91	+9
California	14		29		24		32		31		35		165	+21
Colorado	8		19		27		35		40		39		168	+31
Connecticut	1		3		3		5		3		5		20	+4
Delaware	65		112		134		135		155		171		772	+106
District of Columbia		313		451		585		584		592		506	2,525	+193
Florida	25		44	9	67	14	84	21	101	19	108	21	513	+104
Georgia	5		10	29	11	65	18	74	19	79	26	73	409	+94
Hawaii					1				1		1		3	+1
Idaho							1		1				2	
Iowa	8		7		11		8		8		7		49	−1
Illinois	4		2		2		3		3		2		16	−2
Indiana	3		10		14		19		25		29		100	+26
Kansas	1		1		2		4		4		2		14	+1
Kentucky	2		3		4		8		9		10		26	+8
Louisiana	6		4	1	5	10	13	15	25	18	12	14	97	+20
Maine			1		1						2		4	+2
Massachusetts	2		8		11		7		7		11		46	+9
Maryland	562	17	827	13	914	31	1,053	27	1,128	13	1,069	18	5,672	+508
Michigan	26		33		38		57		89		115		358	+89
Minnesota	4		2				1		2		1		10	−3
Missouri	12		2		6		6		2		3		31	−9
Mississippi			5		6		3		7		4		25	+4
Montana	1		1		2		4		2		2		12	+1
North Carolina	87		163	29	216	107	346	138	509	161	643	105	2,504	+661
North Dakota			1		2		1		1		1		6	+1
Nebraska			1								1		2	+1
New Hampshire			2		2		3		4		4		15	+4
New Jersey	10		16		18		17		27		34		122	+24
New Mexico	2		2		2		4		2		3		15	+1
Nevada							2		2		1		5	1
New York	10		17		30		39		41		44		181	+34
Ohio	22		40	1	53	4	63	8	72	6	69	4	342	+51

ATTACHMENT B.—NUMBER OF AWARD RECIPIENTS—Continued

State	2000–2001		2001–2002		2002–2003		2003–2004		2004–2005		2005–2006		Total	Increase 2000–06
	Public	Private	Public	Private	Public	Private	Public	Private	Public	Private	Public	Private		
Oklahoma	.....	.....	.....	.....	.....	.....	.....	.....	5	.....	9	.....	14	+9
Oregon	1	.....	1	.....	4	.....	4	.....	3	.....	1	.....	14	.....
Pennsylvania	131	.....	186	.....	270	.....	324	.....	335	.....	349	.....	1,595	+218
Rhode Island	1	.....	2	.....	4	.....	3	.....	1	.....	1	.....	12	.....
South Carolina	18	.....	29	2	28	10	39	21	41	23	40	23	274	+45
Tennesee	13	.....	16	.....	29	4	23	5	26	6	39	6	167	+32
Texas	2	.....	7	.....	23	4	29	.....	41	1	48	1	156	+47
Utah	1	.....	2	.....	1	.....	2	.....	4	.....	4	.....	14	+3
Virginia	397	139	599	172	732	151	787	175	734	171	664	144	4,865	+272
Virgin Islands	.....	.....	.....	.....	.....	.....	.....	.....	1	.....	6	.....	7	+6
Vermont	7	.....	7	.....	13	.....	22	.....	30	.....	34	.....	113	+27
Washington	3	.....	4	.....	7	.....	11	.....	14	.....	16	.....	55	+13
Wisconsin	114	.....	21	.....	33	.....	35	.....	49	.....	64	.....	316	−50
West Virginia	79	.....	49	.....	61	.....	65	.....	77	.....	80	.....	411	+1
Grand Total	1,657	469	2,313	708	2,838	989	3,350	1,073	3,713	1,099	3,836	927	22,430	+2,637

ATTACHMENT C



	Don't Know	Ward 1	Ward 2	Ward 3	Ward 4	Ward 5	Ward 6	Ward 7	Ward 8
2000-2001	60	173	96	195	441	350	159	311	181
2001-2002	149	257	159	304	640	502	252	433	282
2002-2003	265	310	196	388	800	627	304	534	375
2003-2004	295	323	194	450	969	695	349	620	491
2004-2005	286	362	192	492	1076	756	378	717	544
2005-2006	202	360	204	511	1050	758	372	723	567

Senator DURBIN. Thank you very much. Judges Washington and King, I direct these questions to you and you can decide between you who will respond.

Budget submissions seek a total of $179.8 million for capital improvements and the President's recommendation calls for $52.5 million, that's only about 29 percent of what you say you need. What capital improvement projects would have to be forestalled, delayed, if we're not able to meet your request?

D.C. COURTS CAPITAL REQUEST

Judge WASHINGTON. I think I'll try to handle that one, Mr. Chairman. The facilities master plan that was developed by the courts back in 2002 addresses all of our space needs and depends on our renovating and moving services out of the Moultrie Courthouse into other court buildings. Then we need to restack the Moultrie Courthouse to consolidate the Family Court to make sure all the services are located in the same family friendly location and that we're providing the breadth of services that we have been asked to provide and we, of course, want to provide to our citizens.

A key part of this swing is to get the Court of Appeals out of the building to free up 37,000 square feet. Once the District of Columbia Court of Appeals is moved into the new building, the Superior Court, the trial court, will be able to use that space. In theory, the Superior Court can then restack and move operations into that vacated space and reconfigure the space that is currently where the Family Court is located to consolidate the Family Court.

There are other buildings on our campus that will have to absorb some of the other Moultrie operations. So, ultimately, what the lack of funding ends up doing to us, is delaying all of these projects.

In fact, those projects are then pushed back in time. Projects that are not funded include the Moultrie Courthouse renovation. I spoke about the Moultrie Courthouse renovation and reorganization and the restacking process and there are a number of projects that fall into that category, as you can imagine, when you're trying to reconfigure that space.

In addition we need to move some of our operations, as I said, out of the Moultrie Courthouse into Building C, another building on our campus in order to consolidate our space and make room. That modernization project is not funded and those are the two large capital projects that will impact our ability to finally reconfigure Moultrie into the kind of Family Court and trial court that we want it to be.

So, in essence the delay is a creating this gap between our move, the Court of Appeals move, out of the Moultrie building into the new Court of Appeals building and the opportunity that the Superior Court will have to configure their operations to meet the mandates that have been imposed.

Senator DURBIN. So if you had full funding, what's the time line?

Judge WASHINGTON. If we had full funding, I would.

Senator DURBIN. At your request.

Judge WASHINGTON. Yes. If we had the full funding right now, I would have to turn to our Administrative Services Director. There's a design phase that we have not undergone yet that precedes each of these restackings because we have to have money to do the design phase.

Our best estimate is that if we got the funds today for these projects we would complete the renovations on our campus in 4 years.

Senator DURBIN. And so if you receive the President's recommendation, is that enough money for the design phase of this project?

Judge WASHINGTON. No. The monies that are in the President's recommendation will only cover those costs that are associated with the old courthouse and the emergency electrical repairs.

So, the monies for the design of the reconfigured Moultrie building are not included in the President's recommendation in this budget.

Senator DURBIN. I would like to address the perimeter security questions, and you talked about the need for $16 million for perimeter security enhancements. Could you tell us a little bit about that?

Judge WASHINGTON. If I can. This is based on a study by the U.S. Marshals Service.

Let me preface this by saying that we've now moved back out onto our campus, through renovation of Building A. We are moving services and courtrooms into that facility, and into the old courthouse in fall 2008, hopefully, maybe the winter 2009.

The need to create a perimeter around all of the campus has increased because we now will have critical operations in every build-

ing. The Marshals Service has determined that in order to protect, not only the courts, but the people who are going to be using our court system, we had to create a perimeter of security. We've done it as part of our master plan for Judiciary Square, a plan that's been approved both by the National Capital Planning Commission and by the Commission of Fine Arts.

It includes security that will protect us from any threat from traffic that may be traveling up and down the public streets or any other attempts to harm the people who work inside the court building.

That also includes perimeter security for the United States Court of Appeals for the Armed Forces, with whom we share space on Judiciary Square.

Senator DURBIN. So the marshals have security responsibilities for the entire campus as opposed to the Federal Protective Service, for example?

Judge WASHINGTON. Yes.

FAMILY COURT

Senator DURBIN. Ok, thank you. Judge King, I didn't mean to misstate your responsibilities earlier, but when we got together it was in establishing the Family Court and there were some projections about caseload and productivity that were made years ago. Can you give me an update on how that's going?

Judge KING. The caseloads have pretty much remained flat and in some cases have gone down a little bit because the city agency, the Child and Family Services Agency, is now not bringing some cases that were automatically sent to court before.

What I can say is that the level of judicial attention, which was very much a discussion at the time of that bill, has gone way up with the result that the cases that are coming in are very strongly supervised and managed in exactly the way that, I think, all of us had in mind at the time of that act. It has given us the strength at the judicial level, the manpower strength, to handle the cases, with the attention and with all of them in the Family Court where they've all been consolidated, now in very much the way that, I think, Congress intended.

Senator DURBIN. Thank you. Mr. Quander, good to see you again. I think we met 5 years ago when I chaired the hearing on your nomination. Thank you for your dedication to public service.

The opening of the final unit of the residential Re-entry and Sanctions Center is conditioned on receipt of funds requested in the 2008 appropriation of $2.1 million. With that funding you indicate you can meet the particular needs of the female offender population. How are you currently addressing those needs?

Mr. QUANDER. The design of the unit is to take a special segment of the female population that has a chronic history of chronic substance abuse coupled with criminogenic factors that indicate that that offender poses a severe risk to the public.

What we're doing now is we're using the drug treatment option and supervision options that we have currently available, but it's not sufficient to address the needs of this special type of offender. The benefits that the Re-entry and Sanctions Center allows is that

we will have an opportunity for 28 days to really assess—to really prepare that individual for treatment.

It's almost like we are enhancing our investment in substance abuse treatment because a lot of the women have a lot of issues that some of the men don't have, child care issues. Many of the women have been victims of crimes. There's a lot of reasons why they fall victim to substance abuse.

The contract treatment works better if we can provide a road map for the treatment provider as to what some of those underlying issues are. We will stand a better chance of getting those women through the process successfully and united with their families.

So, the Re-Entry and Sanctions Center serves as a much needed bridge, especially for this population that has so many other issues than the men, but there's a tremendous need.

Just yesterday, I was visiting a facility in Northern Virginia that actually houses women and their children. It's a special facility designed to meet their needs with a lot of emphasis in the mental health area, substance abuse, child care. It's a wrap around facility. It's that type of approach that I think will get us the best results as we invest in the future of these offenders because we think that they can make it. We know they can, if they're given the proper support and the RSC will allow us to give that proper support.

Senator DURBIN. How many persons does the Sanctions and Reentry Center presently serve?

Mr. QUANDER. Now, we have, I believe four floors that are operational. When it's fully operational with the six units, we'll be able to treat at least 1,200 people in the center throughout the course of the full year.

We're anticipating that the next unit to come on line will be the mental health unit and then subject to the funding for 2008, we will bring the women on board.

Senator DURBIN. So, 1,200 for the entire year?

Mr. QUANDER. For the entire year, once we're fully staffed and operational.

Senator DURBIN. Say at this day, what do you think your census or population is today?

Mr. QUANDER. It is probably in the area of about 80.

Senator DURBIN. What portion of those served are newly released parolees?

Mr. QUANDER. The vast majority of the individuals, the males that are in the facility now are newly released parolees. We have four floors that are in operation now.

One of the four floors is a pretrial services floor. Another is a sanctions floor for those individuals who have been in the community but have started to slip—who have started to fall. The beauty of this program is that it allows us to get them before we have to go to court, before we have to do any other type of intervention and bringing in another party.

We can get them back into the center, get them readjusted and get them refocused on their mission and on their purpose. So, it gives us great flexibility without taxing some of our partners before it's really time to bring them in.

Senator DURBIN. What proportion of those you serve present substance abuse problems?

Mr. QUANDER. Seventy percent of the individuals that we see on probation, parole, supervised release, for sentencing agreements or civil protection orders upon entry into supervision are testing positive for substance abuse.

Our population, as we test, at least 51 percent of the individuals that are undergoing consistent testing with the agency, have tested at least once, positive, 51 percent, but at intake it's close to 70 percent.

Senator DURBIN. I think we talk a lot about recidivism and you've been observing a population that is prone to recidivism. What do you think poses the greatest challenge there that we should be considering? Is there one element that clearly needs more attention or more resources?

Mr. QUANDER. It's always a tough question, but if I had to limit it just to one area, I would have to concentrate on the area of substance abuse. The reason I say that is, when you talk about maximizing your resources, the research is very clear. There is no dispute anymore, but that substance abuse treatment really works.

It has an impact on reducing crime. It has an impact on reducing those individuals who are in the criminal justice system, but it also has an impact, as we spoke earlier about the women, because women have children and if they have children and if the mothers are using, they're not providing the type of supervision.

So, those children are essentially guaranteed to come into the criminal justice system. If we don't address the problem—and so that would be the one area that—if I had to limit it to just one.

I think that there should be additional attention and resources, and I think you get the best return on your investment if we go in that direction.

Senator DURBIN. Your top priority reported here is in reducing caseload ratios for community supervision officers and I believe this should be replicated if it could be with pretrial services agencies.

Mr. QUANDER. Yes.

Senator DURBIN. You stress an additional $1.6 million and nine FTEs will enable you to lower your PSA officer ratio to 75 to 1. How does that compare to other jurisdictions in the region?

Mr. QUANDER. Actually, if we received what is requested in the President's budget, that would be a tremendous step in the right direction and will allow us to meet our goals. But it is still higher than some of the surrounding jurisdictions that have a lower case load.

It is manageable. It was extremely high. We can work with the 75 to 1 ratio, but it is higher still than some of the surrounding jurisdictions.

Senator DURBIN. Give me a comparison number, pick it from the sister jurisdiction as to what the ratio number might be.

Mr. QUANDER. 65 to 1 in Montgomery County. I believe in the Norfolk, Virginia area, it's as low as 45 to 1.

Senator DURBIN. Thank you. Ms. Buchanan, how much is a public defender paid in the District?

Ms. BUCHANAN. Our salaries are Federal General salaries; attorneys with no experience generally enter at the GS–11, step 1 rate, which is approximately $55,000, and, based upon seniority they can go up to GS–14, step 10.

Senator DURBIN. And the grade 14?

Ms. BUCHANAN. Very few staff attorneys remain at PDS long enough to attain the GS–14, step 10 staff salary which is approximately $120,000.

Senator DURBIN. What kind of luck do you have in recruiting attorneys for $55,000 a year?

Ms. BUCHANAN. PDS is special, and employment at PDS is highly sought after; we average approximately 600 applicants for what works out to be six to eight openings per year in PDS's Trial Division, our largest group of lawyers. We hire once a year in the Trial division. We do that because we train the attorneys before they are permitted to handle any cases. Every year, we receive many applications from the top students at the top law schools across the country.

So we have not experienced any problem recruiting highly qualified and motivated candidates. People do not come for the salaries; they come because they're dedicated to PDS's mission and to our clients.

Senator DURBIN. And what's the usual tenure of these public defenders? How long do they stay at the agency?

Ms. BUCHANAN. Staff attorneys' tenure varies widely. We ask for a minimum 3-year commitment, but we have attorneys who have remained at PDS for as long as 14 or 15 years—those are the outliers. I would say that our attorneys stay an average of 5 to 6 years.

Senator DURBIN. I've been trying to pass a bill here, passed it in the Senate Judiciary Committee, for a student loan repayment for State and local prosecutors and defenders.

Ms. BUCHANAN. Yes.

Senator DURBIN. Is this an issue with your new attorneys?

Ms. BUCHANAN. Yes. Many of our attorneys come to PDS saddled with heavy debt loads and continue to work at PDS with these heavy debt loads. We've been intently following your legislation as it would benefit many of our attorneys. The District of Columbia has enacted its own student loan repayment program and we are trying to have our attorneys become eligible for this program.

Senator DURBIN. Are they participating now?

Ms. BUCHANAN. No, right now the D.C. Bar Foundation, which administers the program, has deemed PDS attorneys to be ineligible to receive these benefits primarily because of PDS's quirky status as being neither Federal nor State or district. Because we are federally funded, the D.C. Bar Foundation considers our attorneys ineligible for the program, however, we continue to work with the foundation to change this determination.

Just today, I had another conversation with the foundation about a different rationale for having our attorneys become eligible to participate in that program.

Senator DURBIN. Back in the dark ages when I was a student at Georgetown Law School, I can recall the Defender Program in the District. It enjoyed a great reputation then, but the numbers you

just given me of 600 applicants for six jobs is an amazing indication.

Ms. BUCHANAN. Yes.

Senator DURBIN. Of what a challenging professional opportunity you offer.

Ms. BUCHANAN. PDS is a wonderful place, and there are several of us who have left PDS and returned. I am one. PDS's deputy, Peter Krauthamer, and PDS's general counsel, Julia Leighton, who are here with me, are others. PDS is a very special place. It's hard to leave and it's wonderful coming back. I have no regrets.

Senator DURBIN. Great, thank you.

Ms. BUCHANAN. Thank you.

Senator DURBIN. Ms. Gist, if you take a look at the national average of college graduation for low income minority students, it's 47 percent and if you take a look at the D.C. TAG experience, the 2000/2001 freshman class, 38 percent graduated from college. In the next year D.C. TAG, 2001/2002, 36 percent graduated. Why do you think there's that disparity?

Ms. GIST. Well part of the reason is that the national average that you're referring to is based on a 6-year graduation rate.

And actually I can update you with some new numbers that we have based on more students from the cohorts that we have information about who's graduated.

So, just as an example from the 2000/2001 cohort, we have a 46-percent graduation rate. So we were.

Senator DURBIN. So, its 6 year to 6 year, is that what you're saying?

Ms. GIST. Well, it's kind of hard for us to compare year to year, but it's definitely not more than 6 years because it hasn't been 6 years, so, less than 6 years.

We now know that it's 46 percent for that cohort, right now, 41 percent for the 2001/2002 cohort and 40 percent for the 2002/2003 cohort. So, again, compared to a 6-year rate, we feel confident about those graduation rates.

So, I will also say that we have, even with that, I mean, retention has become a very big issue for us. We are a leader in the "Double The Numbers" initiative in the District of Columbia, which is a District-wide effort to focus on college going and college graduation and so, for example, we are the lead on a sector group that's working with college access providers across the District.

Right, exactly that was the report that kicked it off and so retention is a serious priority for us right now.

Senator DURBIN. The process you go through is fairly automatic in terms of qualification for assistance and so I'm wondering if your agency takes a look at any of these factors that lead to information about why 60 percent, or 59 percent, fail to graduate.

I know that you're getting closer to the national average, but the national average is disappointing too.

Ms. GIST. Yes.

Senator DURBIN. So, do you have any anecdotal evidence or personal experience with the students that would give some guidance?

Ms. GIST. Well, we definitely have anecdotal evidence. We have a lot of anecdotal evidence because we work daily with these students and we see what they experience in trying to go to college

and many times they're coming back because of the family situation and they have to come back to work to help support their family, just as an example.

But, I'll also say that we have done a lot to improve our data system and our collection of data. So that we can do a more sophisticated analysis to help us to target services to students, such as—are these financial situations that are occurring, are they social? Do they need psychological/social types of support to help them stay in school and like I said this is a major priority for us right now.

Senator DURBIN. And it goes without saying that those who don't finish college, even with your assistance, may end up carrying a student debt out of that experience even if they don't carry a diploma out of it.

Ms. GIST. That's true and District students unfortunately end up taking a lot of remedial courses their first year and that's something that we're focused on right now, too, is making sure that all of our students are graduating college ready.

Because what we know is that they end up taking remedial courses and so they are paying, essentially, to make up for what they didn't get in K–12 and that's just unacceptable.

So we need to have them graduate from high school, college ready, work ready, and college ready, so that when they hit college, they're earning credit toward graduation from the first day, which right now, most of our students are not doing.

Senator DURBIN. And that's not unique to the District of Columbia. In the State of Illinois, about 50 percent of those admitted to community colleges are not performing at 12th grade level. They spend the first year or two trying to catch up to what they should have learned in high school.

Ms. GIST. Right.

Senator DURBIN. They call themselves college students, but they're really trying to become college students, and paying college tuition in many places to reach that goal.

Is there going to be change in the differential between in-State and out-of-State tuitions at the major schools that you provide students for? Maryland and Virginia, I think account for almost one-half of the students from the District of Columbia. Over the period of this program, has there been a change?

Ms. GIST. Yes, and we've definitely seen the average amount that each student gets per year creeping closer and closer to the cap which is $10,000 per year. In fact, I believe, I'm not sure if we gave you this chart, but we do have a graphic that shows the increase in the, like I said, it's pretty dramatic if you look at the numbers of students who are now either at the cap or close to the cap; thanks, John.

Senator DURBIN. The $50,000 cap?

Ms. GIST. Right, well the $10,000 per year—right—for the maximum. So, for example in 2000/2001, well actually, I'll use the second year because the first year was a bit of an outlier.

But in 2001/2002 school year we had a total of 202 students who were at or above the $10,000 a year differential and in the past school year, that was 989. So, it has increased and that's due largely to the increases in the costs of tuition.

Senator DURBIN. But what we're focusing on is the difference between in-State and out-of-State college tuition, are we not?

Ms. GIST. Right.

Senator DURBIN. What I'm asking is whether over the years have universities, like the University of Maryland and University of Virginia increased that differential between in-State and out-of-State?

Ms. GIST. The States tend to, when we're increasing tuition, they're more likely to increase the out-of-State tuition than they are the in-State tuition for obvious reasons. So, yes, that difference has increased.

Senator DURBIN. Let me talk about the total amounts of money here. I've been through this before when we created this program and I've watched it.

In the first 4 years of the program, Congress appropriated $17 million annually. The President sought the same level in fiscal year 2005, but the amount appropriated increased 49 percent to $25.6 million, and then in 2006, another 30 percent increase to $33.2 million. The funding you seek this year is double what was provided in each of the first 4 years and it concerns me.

Now, when we put in the appropriations bill to the District of Columbia the following language last year, the subcommittee remains concerned of significant annual funding increases in the brief 2 year span, it was a signal that program costs have the potential of growing well beyond the level at which future Federal funding may be available or sustainable.

So to address this concern, the subcommittee directed the Mayor and the D.C. State Education Office, which I know you're associated with, to work closely with Congress to take steps to institute effective cost contained measures and regular reports to Congress about the effects of these efforts.

The subcommittee directed the District to fully explore non-Federal sources of additional funds to augment Federal investment, so what cost contained measures have you instituted?

Ms. GIST. There are several that we've already instituted and then there are many others that we've studied that are much more dramatic. We hope that we won't have to institute those.

The ones we've already instituted include reducing the total amount for community college reimbursement, eliminating summer school. We no longer pay for summer school, creating 24 years of age as the maximum for participation in this program and establishing 6 years as a maximum amount of time that students have from the first semester they're enrolled to receive funding.

So, those are just a few things we've done already. We've also seen, Senator, the costs, although they have continued to rise, see them begin to level off. While it looks quite dramatic that it's now 35 and it was 17 for several years, the actual growth has been very, very consistent over those years.

The reason that the requested appropriation was staying the same and then increased so dramatically was because there was carryover. So even in the first year, for example, there was about $20 million in carryover, but then was able to be used and each year we've sort of dipped deeper and deeper into that carryover to today where we have very little carryover.

Senator DURBIN. You said that there were some more strenuous ideas that you hoped you didn't have to turn to. What would they involve?

Ms. GIST. Yes, those are, you know, we could reduce the maximum award from $10,000, but as I've shared with you already, we have students at the maximum and I'll remind you that what this program does is essentially levels the playing field for our students, so our students still have to come up with a tuition just like any other student in this State and then they also have to come up with their room and board and their books and so forth.

And so, if they're having to come up with their tuition and then they're also having to pay anything that's over the cap which is—right now—$10,000 then that's just an added burden. So if we had to reduce that to $8,000 for example, that would affect a significant number of students.

We've also looked at the possibility of making it a needs based program if we had to, make it a merit based program.

But again, this dramatically changes the intention of the program, which was to mimic a State university for the system, the way that other students in other States have and a student in another State, a student doesn't have to be, demonstrate need in order to pay the in-State tuition rate or doesn't have to have a certain grade point average (GPA) to pay the in-State tuition rate.

And I'll also just add quickly that we have seen increases, the District has committed increased funding to other types of programs. So, for example, we overmatched by a 5 to 1 factor, the D.C. LEAP Program which is, of course, as you know, a Federal program, but we match it 5 to 1 in order to provide needs based aid for students and we also, Mayor Fenty has a new program in his budget for this year that's focused toward adults who are attending school, since these programs don't support those residents.

Senator DURBIN. What percentage of the students who are assisted by this program are Pell grant eligible?

Ms. GIST. Sixty-eight percent, as determined by their estimated family contribution are very low or low. I'm not sure how that connects to Pell, but 68 percent.

Senator DURBIN. Have you managed to realize any savings from these changes that you've discussed, cost containment measures?

Ms. GIST. We have, they have not been very dramatic, but we've also, in some cases, like the 6-year cap, the 6-year maximum and the 24 age, those are longer term. Those are savings that we would realize over time.

Senator DURBIN. Now, I want to ask, if I can, if the rest of the panel will bear with me, I don't know how interested you are in the student assistance program, a couple, just maybe one or two more questions.

By our calculations, it appears that you have currently about $7 million in carryover funds going into fiscal year 2008. Is that about right?

Ms. GIST. Well, we carried over $9 million from last fiscal year, but we received, as you know, in 2007, we received $33 million and we carried over $9 million, but we've already spent about $40 million. So, again, we use that carryover each year. So, already this year, we've allocated about, almost $39.5 million for awards.

Senator DURBIN. You seek $35 million this year, I mean, pardon, the next fiscal year, with a carryover of $7 million; it appears that $39 million is the figure that you're going to deal with again.

Ms. GIST. Well, we anticipate having very little carryover this year, about $3 million. At this point we don't know what our carryover will be from 2007 because 2007 isn't over yet.

Senator DURBIN. Your program is authorized for $33 million?

Ms. GIST. The program was appropriated in 2007 for $33 million.

Senator DURBIN. Okay.

Ms. GIST. And that was just due to the continuing resolution. We were actually approved for $35.1 million.

Senator DURBIN. Okay, well, we'll work on that and we'll work with you on that as well and I thank you all for your patience this evening. You're definitely in overtime and it was nice of you to be patient and wait for me to come by here and I apologize for that.

That's not something I like to see happen to anybody. You're all very busy and have important things to do and this is a new subcommittee and I'm trying to learn a lot of things about new programs, some that I have been familiar with, but I thank you for being here, all of you on the panel.

ADDITIONAL COMMITTEE QUESTIONS

We'll keep the record open for my colleagues. Some questions will be submitted to you, if you could respond to them in a timely basis it will help us complete our work on the appropriations bill.

[The following questions were not asked at the hearing, but were submitted to the District for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO CHIEF JUDGE ERIC T. WASHINGTON

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

DISTRICT OF COLUMBIA COURT OF APPEALS

Question. Would you please explain your request for IT improvements, and what is driving the need for upgrades in that area?

Answer. Industry standards recommend replacement of computer systems (LAN/WAN systems) after five years; the Court of Appeals is overdue in meeting that standard, as it installed its current computer system in 2001. Significant needs of the court that will be met by the acquisition of a new LAN include the following.

Client Workstations/LAN–WAN Servers

The court's operating system is Windows 2000, which is no longer "supported" by Microsoft. The court plans to upgrade to a VISTA operating system, which will enhance security of the system and enable the court to obtain continued vendor "support" for the operating system.

A new LAN will also enable the court to move from single to dual processors, which will ensure the capability and usability of current and future software products and prepare the court for imaging and an electronic-filing environment. Storage capacity and speed of operation will be improved by moving from IDE to SATA hard drives on clients and SANS storage systems for file servers and imaging technology.

Switches/Routers

A new LAN will enhance network performance, increase LAN/WAN security, and provide for future growth by moving from 10 mbps hubs to 100/1000 mbps switches and routers. Increased bandwidth is needed for high speed imaging, real-time, internet audio streaming of oral arguments in the court to expand accessibility for the public, and to provide increased access for continuity of operations in case of a disaster. Moreover, upgrading from the current 10 mbps to 100/1000 mbps units would provide greater transmission speeds and improved Internet access for the judges and staff of the court, and for the public.

Back-up Storage Devices

A new LAN will enable the court to upgrade its data back-up capability by moving from an analog tape back-up to a digital or optical back-up system. Such an upgrade will provide increased data back-up storage capacity and faster restore speeds.

DISTRICT OF COLUMBIA COURTS

Question. Funding for the Old Courthouse restoration has been phased over the past three years. What is the current status of the project and what will be financed with the 2008 request?

Answer. We appreciate the Congress's strong support for this project and the President's support for our fiscal year 2008 request. The restoration of this historic landmark will return the building to its historic use as a courthouse for the people of the District of Columbia. Restoration is key to the Judiciary Square Master Plan, an urban renewal plan to revitalize Judiciary Square and return it to its historic green, park-like setting for public use.

Construction began in 2006 and is expected to be complete early in 2009. On May 25, the massive columns of the portico were raised less than an inch to permit excavation for the large courtroom that will be built underground below the portico.

The construction contract ($99 million) was financed in fiscal year 2005–2007. The 2008 request will cover costs that are not part of the construction contract, such as removal of hazardous materials, built-in furnishings, security, and project reserves.

Question. What have the D.C. Courts done to address the personal services budget shortfall and what impact have these measures had on court operations?

Answer. The gap in the D.C. Courts' personal services budget formed by salary and benefit costs increasing faster than appropriations, as in all federal agencies. Because the D.C. Courts are a small agency and 75 percent of our budget is for personal services, these costs have risen beyond the Courts' capacity to absorb. Our request for fiscal 2008 will provide full funding for all authorized staff positions. We appreciate the President's support of this request.

To address this shortfall, the Courts have taken numerous steps to limit costs and increase efficiency including the following: severely limited hiring; reengineered business processes; given employees compensatory time instead of overtime pay; restricted travel and training; delayed the 2007 cost of living adjustment; restricted purchasing; and requested legislation authorizing the Courts to offer buyouts to give us a tool that is available to federal agencies to help manage our workforce. We thank Congresswoman Norton for introducing legislation last year and hope it will be enacted during the 110th Congress.

The Courts currently have a 14 percent non-judicial vacancy rate, which we cannot sustain without severe negative consequences on the administration of justice in the District. One example of impact on court operations is in our Civil Division, where, due to the staffing shortage, docketing has been delayed. This means that documents filed with the court are not recorded for several days. The Courts' staff is working very hard, in difficult circumstances to maintain the best possible service to the public, under the circumstances.

Question. Please discuss the D.C. Courts' capital budget and plans for facilities.

Answer. The D.C. Courts manage and maintain over one million gross square feet of space in five buildings in Judiciary Square. Our facilities plans focus on renovation of the Old Courthouse for the Court of Appeals to increase available space in the Moultrie Courthouse and consolidation of the Family Court in the Moultrie Courthouse, which necessitates moving support and operational functions out of Moultrie and reorganizing and relocating those operations that will remain.

Building C is the next building to be renovated. It will house the Information Technology Division, one of the divisions scheduled to move out of the Moultrie Courthouse. We must bring other court buildings up to meet current health and safety codes. Of particular concern is the electrical system in the Moultrie Courthouse, which poses serious safety risks to workers. The Moultrie cellblock, which holds hundreds of prisoners each day, also needs to be brought up to current standards. A study detailing the work that needs to be done in the cellblock has been conducted.

Question. What are the D.C. Courts doing to ensure that the public can easily access court services and to provide accountability to the community?

Answer. The Courts' Strategic Plan guides our efforts to enhance access and accountability to the public.

Access

The D.C. Courts have implemented several initiatives to enhance public access to the Courts, including the following:

—The Court of Appeals Education Outreach Initiative is bringing oral arguments to the community in D.C. law schools;
—The Court of Appeals provides on-line access to oral arguments in the courthouse;
—In cooperation with the D.C. Bar and community organizations, the Courts have several self-help centers to assist litigants who do not have attorneys. For example, we have centers in Family Court, Landlord Tenant, and Small Claims;
—The Superior Court has implemented e-filing in civil cases to make it easier to bring a case to court;
—The Courts recently opened a Drop-In Center in Southeast to provide community-based services to juveniles on probation and their families;
—Judicial officers in the Community Courts judges regularly meet in the community with groups such as Advisory Neighborhood Commissions; and
—The Courts' award-winning website provides extensive information on the courts, including contact information, filing procedures, forms, and legal service providers in the community.

Accountability

The Joint Committee has adopted 13 Courtwide Performance Measures to enhance accountability to the public. The measures cover access to court facilities and services, case processing time, treatment of litigants, jury management, fiscal accountability, and facilities management. We are currently gathering baseline data and establishing benchmarks for the measures and plan to issue routine performance reports to the public.

SUBCOMMITTEE RECESS

Senator DURBIN. So this meeting of the subcommittee will stand in recess.

[Whereupon, at 6 p.m., Wednesday, May 2, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

THURSDAY, MAY 9, 2007

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3:09 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Nelson, and Allard.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENT OF HON. KEVIN BROWN, DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

ACCOMPANIED BY:

LINDA A. STIFF, DEPUTY COMMISSIONER FOR OPERATIONS, INTERNAL REVENUE SERVICE

J. RUSSELL GEORGE, INSPECTOR GENERAL FOR TAX ADMINISTRATION, DEPARTMENT OF THE TREASURY

NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, DEPARTMENT OF THE TREASURY

JAMES R. WHITE, DIRECTOR, STRATEGIC ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE

DAVID A. POWNER, DIRECTOR, INFORMATION TECHNOLOGY MANAGEMENT ISSUES, GOVERNMENT ACCOUNTABILITY OFFICE

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. The hearing will please come to order. I am pleased to welcome you to this session before the Financial Services and General Government Appropriations Subcommittee.

Our focus today is on the President's fiscal year 2008 budget request for the Internal Revenue Service (IRS). Funding for the IRS alone constitutes just over one-half of the total amount requested by the administration for the nearly 30 Federal agencies with accounts under the jurisdiction of this subcommittee. Each year IRS employees make hundreds of millions of contacts with American taxpayers and businesses and really represent the face of Government to more U.S. citizens than almost any other agency.

I welcome my colleagues who will join me on the panel later.

Appearing before the subcommittee this afternoon is a distinguished panel of witnesses who each bring valuable expertise and experience to their testimony. I welcome: Kevin M. Brown, Acting IRS Commissioner, and Deputy Commissioner for Services and Enforcement; J. Russell George, Treasury Inspector General for Tax Administration (TIGTA); and Nina Olson, the National Taxpayer Advocate. I look forward to your presentations.

I also want to welcome Linda Stiff, Deputy IRS Commissioner for Operations, accompanying Acting Commissioner Brown.

I acknowledge the helpful contributions of the Government Accountability Office (GAO) in response to our request for analyses. I welcome senior GAO officials James R. White, Director of Strategic Issues, and David Powner, Director of Information Technology Management Issues, and members of their team. Their prepared statement will be made part of the record and they stand ready to respond to questions.

In addition, the IRS Oversight Board has submitted for inclusion in the record its special report on the recommendations for the fiscal year 2008 budget proposal. Colleen Kelley, President of the National Treasury Employees Union, on behalf of the employees of the Internal Revenue Service has submitted a written statement. Without objection, these materials will be made part of the record.

[The information follows:]

The IRS Oversight Board Fiscal Year 2008 IRS Budget Recommendation Special Report can be found at http://www.treas.gov/irsob/reports/fy2008-budget-report.pdf.

Senator DURBIN. The Internal Revenue Service administers tax laws and collects the revenues that fund over 95 percent of the Federal Government's operations. With approximately 100,000 employees, the IRS is effectively the accounts receivable department for the United States. Simply stated, the more revenue the IRS collects, the more revenue Congress may spend on programs and use for cutting taxes and reducing the deficit. Conversely, the less revenue the IRS collects, the less revenue Congress has available.

The IRS relies on three sources for the funds it needs to operate: appropriated funds, user fees, and reimburseables, which are payments the IRS receives from other Federal agencies and State governments for services provided. Nearly the entire budget, 97 percent of it, is derived from appropriated funds.

For fiscal year 2008, the administration is seeking a direct appropriation of $11.1 billion, an overall increase of $498.4 million, 4.7 percent above the 2007 full year continuing resolution level. The full year joint continuing resolution enacted for fiscal year 2007 provided funding of nearly $160 million more to the IRS than the earlier continuing resolution allowed. So we are hopeful that the resources are there.

I am not going to go into the details breaking down the entire budget. I would rather have the testimony from our panelists. There are a few issues that will be discussed in depth today as we examine the IRS funding. First, the tax gap. The great majority of Americans pay their fair share of taxes. There is still a significant tax gap, the difference between what taxpayers are supposed to pay and what they actually pay. The estimated gross tax gap of $345 billion consists of: underreporting tax liability, $285 billion;

nonfiling of tax returns, $27 billion; and underpayment of taxes, $33 billion.

I note that as a part of its budget submission the IRS proposes 16 legislative reforms to recoup $29 billion, 10 percent of the $290 billion net tax gap, over 10 years. Questions have been raised that such an approach is far from aggressive and amounts to a return of just a penny on the dollar. I am anxious to hear the perspectives of our panel members.

Second, we are going to consider the proper balance between enforcement and service. It is fundamental that as enforcement initiatives to boost compliance are advanced, resources devoted to taxpayer services are not sacrificed. Taxpayer service plays an integral role in facilitating voluntary compliance with our tax laws.

Third, critical information technology enhancements. I am interested in the status of the IRS business systems modernization program, efforts that the IRS migrates from its antiquated and obsolete legacy systems to bring tax administration systems to a level equivalent to private and public sector best practices. This is a challenge in almost every Federal agency.

I would like to turn now to our panel and invite Acting Commissioner Brown to begin. I ask you to make your presentation. We will make your written statement part of the record and we may have some questions to submit to you after the hearing. Possibly some of the other colleagues who cannot join us will send questions as well. So if you would not mind starting, I invite your testimony, Mr. Brown.

ORAL STATEMENT OF ACTING COMMISSIONER KEVIN BROWN

Mr. BROWN. Good afternoon. Thank you, Chairman Durbin. I also want to thank the other members of the subcommittee who will be coming for their efforts in increasing IRS funding in the joint resolution over the level proposed under the continuing resolution.

The President's request for fiscal year 2008 provides additional money for IRS systems, infrastructure, and modernization, as well as for enforcement and, notably, for increased research. There is also an increase for taxpayer services. We ask the members of the subcommittee to support the President's budget and to help enact an appropriation before the start of fiscal year 2008.

These requested moneys will help us generate continued progress in attacking the tax gap. But they are not the only things we need to do. The administration has made 16 legislative proposals. I would direct your attention to four that I think are particularly important: first, the reporting of credit card gross receipts; second, making the willful failure to file a tax return a felony rather than a misdemeanor; third, requiring basis reporting for sales of securities; and fourth, lowering the threshold for mandatory electronic filing for large corporations and partnerships.

With this budget, we can build on our progress in service and enforcement. We again enjoyed significant increases in our enforcement results in fiscal year 2006 and I am pleased to report that we are making continued strides in fiscal year 2007. I believe the IRS has restored the credibility of its enforcement programs with-

out generating a significant amount of public discontent or increased allegations of infringement of taxpayer rights.

In addition, to improve our service to taxpayers we have developed a taxpayer assistance blueprint. This subcommittee was the principal force in bringing about the taxpayer assistance blueprint. Begun in July 2005, the blueprint is a collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate. Under this project we learned a great deal about taxpayer needs and how to meet them. From the blueprint, we created a strategic plan with a host of improvement initiatives. For example, our 2008 budget request includes funding for telephone service and web site enhancements recommended by the strategic plan.

Before taking your questions, let me say a few things about the filing season we just completed. At the IRS we recognized some time ago that this would be a challenging filing season. Two of the reasons were Congress' late action on the extender legislation and the fact that we did not have an operating budget until well into February. The one-time refund of the telephone excise tax and the initiation of the split refund were also of concern. Taken together, we anticipated the most difficult filing season in a number of years.

Nevertheless, we kept up with the work and the system functioned well. The extenders were successfully implemented and our software updates were taken care of by early February. Electronic return filing continues to grow and our service indicators are healthy.

Along with the increase in the e-file rate, we have seen a 17 percent gain in our volunteer-prepared returns, a cornerstone of our outreach program. As you may know, this effort helps eligible participants claim the earned income tax credit.

PREPARED STATEMENT

Thank you for the opportunity to testify today and I will be glad to take your questions.

Senator DURBIN. Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF KEVIN BROWN

INTRODUCTION

Chairman Durbin, Ranking Member Brownback, and members of the Subcommittee, thank you for the opportunity to testify today on the fiscal year 2008 budget request for the Internal Revenue Service. I am accompanied this morning by Linda Stiff, IRS's Deputy Commissioner for Operations and Support. She will assist me in responding to questions that Members of the Subcommittee may have.

Under the leadership of Commissioner Everson, our working equation at the IRS has been and continues to be that service plus enforcement equals compliance. A balanced program between service and enforcement leads to sound tax administration.

However, a balanced program can be successful only if the IRS is provided the resources necessary to fulfill its mission. Two years ago in the fiscal year 2006 budget, the Service was provided those resources when Congress approved the President's request for the IRS. This fiscal year, however, we were forced to operate under a Continuing Resolution (CR) for the first four months of the fiscal year until Congress approved the Joint Resolution (JR) in February.

I want to thank the Members of the Subcommittee for their efforts in increasing our level of funding in the JR over the levels proposed originally under a full year CR. As a result, we anticipate that there will be little or no negative impact on our

taxpayer service, operations support, or our Business Systems Management (BSM) programs.

While our enforcement programs also fare much better under the JR, the increase is not sufficient to prevent some negative impacts. The JR provided $4.7 billion for enforcement, which is $55.4 million below the level requested by the President in his fiscal year 2007 budget request.

While we are attempting to partially offset this reduction through user fee receipts, this reduction increases the importance of providing full funding of our fiscal year 2008 budget request, which I will discuss later in my testimony.

PRODUCING RESULTS

The best case for full funding of the fiscal year 2008 budget can be made by looking at the results we achieved with the resources we do have. In fiscal year 2006, we spent just 42 cents to collect each $100 of tax revenue, the third lowest figure in the last 25 years and down from 46 cents in fiscal year 2005.

In fiscal year 2006, we continued making improvements in both our service and enforcement programs. This claim is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards "transforming itself into a modern institution that provides efficient and effective tax administration services to America's taxpayers."

Improving Taxpayer Service

According to a survey commissioned by the Board in 2006, taxpayers increasingly recognize that the IRS provides quality service through a variety of channels, such as our Web site, toll-free telephone lines, and Taxpayer Assistance Centers (TACs). This finding is supported by the metrics that we use to determine the effectiveness of our taxpayer service efforts. In category after category, we continue to see improvement in the numbers in our telephone services, electronic filing, and IRS.gov access. This improvement is demonstrated by the following fiscal year 2006 business results:

—Electronic filing by individuals continued to increase. It rose three percentage points from fiscal year 2005 to 54 percent of all individual returns.

—The level of service for toll-free assistance was 82 percent, about the same level of fiscal year 2005 and up substantially from fiscal year 2001. The level of customer satisfaction with the toll-free line remains 94 percent.

—The tax-law accuracy of toll-free responses improved to 91 percent and account accuracy increased to over 93 percent.

—Visits to the IRS Web site jumped nearly 10 percent in fiscal year 2006 to more than 197 million visits.

—More taxpayers used the online refund status tool "Where's My Refund." In fiscal year 2006, there were 24.7 million status checks, up nearly 12 percent from fiscal year 2005.

At the IRS, we continue to work to improve services. Clearly, we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the completion of the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July 2005 in response to a Congressional mandate to develop a five-year plan for taxpayer service delivery. We sent Phase 1 of the Blueprint to Congress in April 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer, partner, and government value:

—*Improve and expand education and awareness activities*.—This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.

—*Optimize the use of partner services*.—This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.

—*Enhance self-service options to meet taxpayer expectations*.—This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.

—*Improve and expand training and support tools to enhance assisted services*.—This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.

—*Develop short-term performance and long-term outcome goals and metrics*.—This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

We delivered Phase 2 of the Blueprint to Congress in April. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year TAB Strategic Plan for taxpayer service.

The TAB Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder, partner, and employee engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance.

The fiscal year 2008 budget request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the TAB Strategic Plan. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help. The TAB Strategic Plan also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding noncompliance, the fiscal year 2008 budget includes funding for research to understand better the effect of service on compliance.

Expanding Enforcement Efforts

Another reason for the Oversight Board's positive assessment of our work in fiscal year 2006 is that IRS enforcement efforts have increased in virtually every area. According to the Board, "As demonstrated by a variety of measures, the IRS' performance on enforcement has improved considerably, and real progress has been achieved over the past six years." One of the most obvious measures is the increase in enforcement revenue, which has risen from $34 billion in fiscal year 2002 to almost $49 billion in fiscal year 2006, an increase of 43 percent.

In fiscal year 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This level is almost 75 percent more than were conducted in fiscal year 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.58 percent in fiscal year 2001 to more than 0.97 percent in fiscal year 2006.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over $1 million. The number of examinations in this category rose by almost 78 percent compared to fiscal year 2004, the first year the IRS began tracking audits of individuals with income over $1 million. The coverage rate has risen from 5 percent in fiscal year 2004 to 6.3 percent in fiscal year 2006.

Growth in audit totals and coverage rates extend to other taxpayer categories. Preliminary estimates show that the IRS examined over 52,000 business returns in fiscal year 2006, an increase of nearly 12,000 over fiscal year 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over $10 million, examinations rose from 8,718 in fiscal year 2001 to 10,578 in fiscal year 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over $250 million, examinations have increased by over 29 percent growing from 3,305 in fiscal year 2001 to 4,276 in fiscal year 2006.

We have also been active in the tax exempt community. Overall, examination closures for tax exempt organizations have risen from 5,342 in fiscal year 2001 to 7,079 in fiscal year 2006. In addition, we have an innovative program utilizing correspondence contacts to leverage our activities in the compliance area. We have used it successfully in the hospital and executive compensation areas, and will be using it elsewhere.

While examinations in the tax exempt community generally do not provide the tax collection "return on investment" that audits in other areas might, it is important that we keep a "cop on the beat" in order to prevent abuses in the exempt sector and an erosion of the tax base. Maintaining a strong enforcement presence in the

tax-exempt sector is particularly important given the role that a small number of these entities have played in the past in accommodating abusive transactions entered into by taxable parties. In appropriate cases, this results in the collection of income or excise taxes—and in the most egregious cases, revocation of exempt status.

One area to which we have paid particular attention is the credit counseling industry. Through a compliance initiative in this area, as of March 23, we had revoked or proposed revocation of the tax-exempt status of 45 credit counseling agencies, with another 16 examinations still in process. Proposed or final revocations to date represent 41 percent of the revenues of the credit counseling industry.

Using our correspondence contact techniques, we have also sent more than 700 questionnaires to all tax-exempt credit counseling organizations we know of that were not already under examination. Based on responses to the questionnaires and our independent research, we expect to examine at least 82 additional credit counseling organizations from this group.

We also have been actively reviewing seller-funded down payment assistance programs that provide cash assistance to homebuyers who cannot afford to make the minimum down payment or pay the closing costs involved in obtaining a mortgage. When properly structured and operated, down payment assistance programs can qualify as tax-exempt charitable and educational organizations. In May 2006, we issued Revenue Ruling 2006–27, which provides examples of organizations that may qualify for tax exempt status, but also makes it clear that organizations providing seller-funded down payment assistance do not qualify for tax exemption.

Seller-funded down payment assistance programs improperly benefit the home seller through circular funding arrangements that result in the home buyer paying for all or much of the down payment "gift" he or she receives from the organization. They also result in buyers becoming overextended as the cost of the down payment is added to the purchase price of the home. A Housing and Urban Development (HUD)-commissioned study and a Government Accountability Office (GAO) report found that seller-funded programs led to underwriting problems and resulted in an increase in the cost of homeownership.

In the audits we have conducted in this area, not only have we found improper private benefit and activities, but also that the down payment assistance organizations often provide excessive compensation to their officials. Revocation of exempt status will shut down abusive seller funded programs without harming the innocent low income home buyers who participated in these arrangements.

We will continue to look at other areas within the exempt sector that have the potential for abuse.

2007 FILING SEASON

The progress made in fiscal year 2006 has continued during the 2007 filing season despite the fact that this filing season presented the potential to be one of the most challenging in recent memory. The Tax Relief and Health Care Act of 2006 (TRHCA), which passed late last year, included the extension of several significant tax benefits. Since forms and publications for Tax Year 2006 were printed and distributed prior to enactment, we were required to notify taxpayers on IRS.gov as to how to modify those forms to claim the allowable benefits. Due to separate developments in the tax law, we were faced with implementing the Telephone Excise Tax Refund Program (TETR), and this was the first filing season that we allowed taxpayer refunds to be split and deposited into separate accounts. Finally, because the normal April 15th filing date fell on a Sunday and the following Monday was a legal holiday in the District of Columbia, we had to adjust our programs to provide taxpayers an extra two days to file and pay this year. Many of these changes also necessitated significant changes in our information technology systems.

Despite these challenges, I am proud to report that the filing season has gone very well. By early February, we were able to begin processing tax returns claiming the tax benefits authorized by the enactment of TRHCA in December. We have also taken a number of steps to make sure that taxpayers understand how to claim the benefits. For example, we provided instructions on IRS.gov and conducted extensive outreach and media events to publicize these provisions. In addition, we sent a special mailing of Publication 600, which included the state and local sales tax tables and instructions for claiming the sales tax deduction on Schedule A (Form 1040), to six million taxpayers who had previously claimed the state and local sales tax deduction.

From a technology perspective, we were able to deliver the timely release of 329 of 330 information system for the 2007 filing season. The one exception to timely delivery was the enhancements to the Customer Account Data Engine (CADE). This

system, one of key components of the IRS' modernization strategy, will ultimately replace the antiquated master files.

Significant functionality was added to CADE this year. We included the ability to handle married taxpayers, dependents, and a number of schedules including Schedules C, D, E, F, and SE. Due to system testing issues, the IRS did not deploy CADE into production until March 6th. To ensure taxpayers filing prior to March 6th were not negatively impacted, the IRS continued to process CADE-eligible taxpayers through the master file. Hence, the impact to such taxpayers was a delay of a couple of days on refund processing.

The IRS originally estimated that if the enhancements were put into production on time, we would have processed 33 million individual tax returns through CADE in 2007. Given that we were late and missed many of the taxpayers that would be now be CADE-eligible, we processed only 10.4 million tax returns through CADE as of May 4th. While the 10.4 million tax returns are more than the 7.4 million posted last year, it is still disappointing because it fell well short of our estimates. CADE is now operating well in production and we expect that the full functionality intended for this year will be there for CADE going forward.

Because of the issues with getting CADE into production this year, the IRS is taking more management control of the CADE project, and working to embed additional IRS subject matters experts on the CADE team. A significant amount of the delay this year is attributable to the complexities of the interfaces between CADE and other IRS legacy systems.

In planning for next filing season, the IRS is revisiting the scope of what is to be delivered, to ensure that CADE will be in production the first day of the 2008 filing season.

I will discuss the TETR Program later in my testimony, but let me first give an update on our filing season numbers.

Numbers Thus Far

We expect to process almost 136 million individual tax returns in 2007, and as anticipated the number of those that were e-filed continued to grow. In the 2006 filing season, 54 percent of all income tax returns were e-filed. As of April 28, we have received over 76 million tax returns electronically, an increase of 8.74 percent compared to the same period last year.

This increase in e-filing is being driven by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by over 11 percent compared to this time a year ago. Over 22 million returns have been e-filed by people from their personal computers, up from over 19 million for the same period a year ago.

Overall, nearly 61 percent of the 125.7 million returns filed thru April 28 have been e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in two weeks or less. That is about half the time it takes us to process a paper return. For the IRS, the error reject rate for e-filed returns is significantly lower than that for paper returns.

More people are choosing to have their tax refunds directly deposited into their bank account than ever before. So far this year, we have directly deposited over 58 million refunds, or 63.2 percent of all refunds issued this tax filing season. This level is up from 62.3 percent for the same period in 2006.

People are also visiting our Web site, IRS.gov, in record numbers. Through April 28th, we have recorded over 137 million visits to our site this year, up over nine percent from 124.8 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the Web site. We have made it easier for taxpayers to get answers to many of their tax questions online. Important functions on the Web site provide capabilities to:

—Assist the taxpayer in determining whether he or she qualifies for the Earned Income Tax Credit (EITC);

—Assist the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);

—Allow more than 70 percent of taxpayers the option to file their tax returns at no cost through the Free File program;

—Allow taxpayers who are expecting refunds to track the status via the "Where's My Refund?" feature; and

—Allow taxpayers to calculate the amount of their Sales Tax Deduction.

As of April 21, we have received 125.7 million returns, a very slight increase (1.4 percent) over the same period as last year. We have issued 91.9 million refunds so far this year, for a total of $209.7 billion. The average refund thus far is $2,280,

$63 more than last year. In addition, as of April 28th, over 26.6 million taxpayers have tracked their refund on IRS.gov, up more than 26 percent over last year.

As of April 28th, our Taxpayer Assistance Centers (TACs) are reporting a very slight increase in face- to-face contacts this filing season as compared to last year. We have seen a slight decline in the number of calls answered (−0.32 percent) as well as automated calls (−5.65 percent). The decline in the number of calls answered can be attributed to a few weather-related temporary call site closures earlier this winter and a slight decrease in overall caller demand.

Free File

Over 3.7 million people have utilized Free File as of April 28, down 1.8 percent from last year. This year, anyone with adjusted gross income of $52,000 or less is eligible for Free File, which includes 95 million taxpayers.

We think there are two major reasons for this decline. First, other websites advertising free tax preparation service siphoned off a significant number of customers. In addition, traditional tax preparation sites such as Intuit and TaxAct offered and advertised their own free services.

Second, taxpayers are inundated with advertising and promotions by major tax preparation firms such as Intuit, H&R Block, and Liberty Tax. This is in contrast with IRS' limited promotion and marketing budget for FreeFile.

A key difference in this year's Free File program is that Alliance members are no longer offering ancillary products, such as refund anticipation loans (RALs), through the Free File program. IRS data from the last filing season shows that only 0.5 percent of Free File users chose to utilize a RAL. The Free File Alliance may still offer customers the option of having their state tax return prepared for a fee, though some Alliance members are offering to do the state return along with the Federal at no cost.

In the 2006 filing season, an indicator was included for the first time on Free File returns that allows the IRS to identify those taxpayers using Free File. As a result, the Service was able to obtain important information such as customer satisfaction and demographic data that had never before been available. This information allowed us to verify that there was a high level of customer satisfaction with Free File. According to a survey conducted for the IRS, 94 percent said they intend to use Free File again next year; the same number said they found Free File very easy or somewhat easy to use; and 97 percent said they would recommend Free File to others. Convenience, not the free cost, was the most appealing factor of Free File.

VITA/TCE Sites and Other Community Partnerships

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased. In fiscal year 2006, over 2.2 million returns were prepared by volunteers. As of April 28, volunteer return preparation is up 17 percent above last year's level. Volunteer e-filing is also up slightly, by 1.7 percent over the same period last year. This is reflective of continuing growth in existing community coalitions and partnerships.

We have also made a concerted attempt to improve outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored EITC Awareness Day on February 1 in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge them to claim the credit.

Telephone Excise Tax Refunds

In the middle of 2006, the IRS announced plans to refund at least $13 billion in telephone excise taxes to more than 160 million taxpayers. To do this task, the IRS modified every individual and business tax return form, retooled our systems to handle the forecast demand, and launched an extensive communications campaign to increase awareness and encourage people without a filing requirement to request a refund anyway.

One difficulty in administering this refund was that taxpayers could have experienced significant burden if they had been required to find 41 months of old phone bills in order to obtain the information they needed to compute their refunds. For this reason, the IRS created a set of standard amounts that individuals can claim in lieu of actual amounts. For businesses and non-profits faced with potentially more paperwork than individuals, the IRS developed an estimation method that could require significantly less paperwork than requesting an actual amount.

A review of returns filed so far this year turned up a surprising fact: over 28 percent of returns we have received did not include a telephone excise tax refund request. Though one of our communications goals was to encourage taxpayers not to overlook the telephone tax refund, it appears many taxpayers are missing out. In

response to these early numbers, we consulted with tax professionals, citizens groups, and tax software companies to determine potential causes for the low take-up rate. The only logical reason we were given was that despite our best efforts, some taxpayers were still not aware of the credit and how to claim it. We then conducted additional media outreach to increase awareness of the refund and were able to generate broad national media coverage, including CNN, the Associated Press, and USA Today.

As we monitored the initial returns, we also noticed some problems. Even though 99.5 percent of all taxpayers who are requesting the refund are claiming the appropriate standard amount, some tax-return preparers are requesting thousands of dollars of refunds for their clients in instances where clients are entitled to only a tiny fraction of that amount. This behavior may indicate criminal intent on the part of the return preparer. In some cases, taxpayers requested a refund in the thousands of dollars, suggesting that the taxpayer paid more for telephone service than they received in income. While some of the large claims may be the result of misunderstandings—a number of refund requests appear to be for the entire amount of the taxpayer's phone bill, rather than just the three-percent long-distance tax—others may be deliberate attempts to scam the system.

To address this problem, in late February, IRS special agents executed search warrants seeking evidence from a small number of tax-preparation businesses suspected of preparing returns on behalf of clients requesting large, improper amounts in telephone excise tax refunds. Special agents temporarily closed these businesses, seizing computers and documents to use in their investigations. In addition, IRS revenue agents (auditors) and special agents also visited other tax preparers who were suspected of preparing questionable telephone tax refund requests.

On a positive note, the number of returns with seemingly high telephone excise tax refunds dropped significantly. This change suggests our enforcement actions, along with increased communications, may be having the desired effect.

Tax Scams

Each year, we alert taxpayers about the "Dirty Dozen," 12 of the most blatant tax scams affecting American taxpayers. This effort is, in part, an effort to alert taxpayers so that they may be wary if approached and encouraged to participate in any of the listed schemes. It also alerts promoters that we are aware of the scam and will be taking steps to prevent them from getting away with it.

This year the "Dirty Dozen" highlights five new scams that IRS auditors and criminal investigators have uncovered. Topping the list this filing season are fraudulent refunds being claimed in connection with TETR, which I have already discussed. Other scams making the list include:

—*Abusive Roth IRAs*.—Taxpayers should be wary of advisers who encourage them to shift under-valued property to Roth Individual Retirement Arrangements (IRAs). In one variation, a promoter has the taxpayer move under-valued common stock into a Roth IRA, circumventing the annual maximum contribution limit and allowing otherwise taxable income to go untaxed.

—*Phishing*.—This technique is used by identity thieves to acquire personal financial data in order to gain access to the financial accounts of unsuspecting consumers, run up charges on their credit cards or apply for loans in their names. These Internet-based criminals pose as representatives of a financial institution—or sometimes the IRS itself—and send out fictitious e-mail correspondence in an attempt to trick consumers into disclosing private information. A typical e-mail notifies a taxpayer of an outstanding refund and urges the taxpayer to click on a hyperlink and visit an official-looking Web site. The Web site then solicits a social security and credit card number. It is important to note the IRS does not use e-mail to initiate contact with taxpayers about issues related to their accounts. If a taxpayer has any doubt whether a contact from the IRS is authentic, the taxpayer should call 1–800–829–1040 to confirm it.

—*Disguised Corporate Ownership*.—Domestic shell corporations and other entities are being formed and operated in certain states for the purpose of disguising the ownership of the business or financial activity. Once formed, these anonymous entities can be, and are being, used to facilitate underreporting of income, non-filing of tax returns, listed transactions, money laundering, financial crimes and possibly terrorist financing. The IRS is working with state authorities to identify these entities and to bring their owners into compliance.

—*Zero Wages*.—In this scam, which first appeared in the Dirty Dozen in 2006, a Form 4852 (Substitute Form W–2) or a "corrected" Form 1099 showing zero or little income is submitted with a federal tax return. The taxpayer may include a statement rebutting wages and taxes reported by the payer to the IRS. An explanation on the Form 4852 may cite statutory language behind Internal

Revenue Code sections 3401 and 3121 or may include some reference to the paying company refusing to issue a corrected Form W–2 for fear of IRS retaliation.

—*Return Preparer Fraud*.—Dishonest return preparers can cause many headaches for taxpayers who fall victim to their schemes. Such preparers make their money by skimming a portion of their clients' refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Some preparers promote filing fraudulent claims for refunds on items such as fuel tax credits to recover taxes paid in prior years. Taxpayers should choose carefully when hiring a tax preparer. As the old saying goes, if it sounds too good to be true, it probably is. Remember that no matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. In recent years, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others. During fiscal year 2006, 109 tax return preparers were convicted of tax crimes and sentenced to an average of 18 months in prison.

—*American Indian Employment Credit*.—Taxpayers submit returns and claims reducing taxable income by substantial amounts citing an American Indian employment or treaty credit. Although there is an Indian Employment Credit available for businesses that employ Native Americans or their spouses, there is no provision for its use by employees. In a somewhat similar scam, unscrupulous promoters have informed Native Americans that they are not subject to federal income taxation. The promoters solicit individual Indians to file Form W–8 BEN seeking relief from all withholding of federal taxation. A recent "phishing" variation has promoters using false IRS letterheads to solicit personal financial information that they claim the IRS needs in order to process their "non-tax" status.

—*Trust Misuse*.—For years, unscrupulous promoters have urged taxpayers to transfer assets into trusts. They promise reduction of income subject to tax, deductions for personal expenses and reduced estate or gift taxes. However, these trusts do not deliver the promised tax benefits. There are currently more than 150 active abusive trust investigations underway and 49 injunctions have been obtained against promoters since 2001. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering into a trust.

—*Structured Entity Credits*.—Promoters of this newly identified scheme are setting up partnerships to own and sell state conservation easement credits, federal rehabilitation credits and other credits. The purported credits are the only assets owned by the partnership and once the credits are fully used, an investor receives a K–1 indicating the initial investment is a total loss, which is then deducted on the investor's individual tax return.

—*Abuse of Charitable Organizations and Deductions*.—The IRS continues to observe the use of tax-exempt organizations to improperly shield income or assets from taxation. This action can occur when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund but maintains control over the assets or income. Contributions of non-cash assets continue to be an area of abuse, especially with regard to overvaluation of contributed property. In addition, the IRS is noticing the return of private tuition payments being disguised as charitable contributions to religious organizations.

—*Form 843 Tax Abatement*.—This scam rests on faulty interpretation of the Internal Revenue Code. It involves the filer requesting abatement of previously assessed tax using Form 843. Many using this scam have not previously filed tax returns and the tax they are trying to have abated has been assessed by the IRS through the Substitute for Return Program. The filer uses the Form 843 to list reasons for the request. Often, one of the reasons is: "Failed to properly compute and/or calculate IRC Sec 83—Property Transferred in Connection with Performance of Service."

—*Frivolous Arguments*.—Promoters have been known to make the following outlandish claims: the Sixteenth Amendment concerning congressional power to lay and collect income taxes was never ratified; wages are not income; filing a return and paying taxes are merely voluntary; and being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy. Taxpayers should not believe these or other similar claims. These arguments are false and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law or else they may subject themselves to increased penalties. As part of the Tax Relief and Health Care Act of 2006 [Public Law No. 109–432], Congress amended the Code to increase the amount of the penalty for frivolous tax returns from $500 to $5,000 and to impose a penalty of $5,000 on any person who submits a "specified frivolous position." Last week,

we released guidance identifying these and other frivolous claims that, when asserted by a taxpayer on a tax return filed with the Service or submitted in a collection due process request, offer-in-compromise, application for an installment agreement, or application for a Taxpayer Assistance Order, expose the taxpayer to the $5,000 penalty.

PRESIDENT'S FISCAL YEAR 2008 BUDGET MAINTAINS THE BALANCE BETWEEN TAXPAYER SERVICE AND ENFORCEMENT

The IRS and its employees represent the face of the Federal Government to more American citizens than any other government agency. The IRS administers America's tax laws and collects 95 percent of the revenues that fund government operations and public services. Our taxpayer service programs provide assistance to help millions of taxpayers understand and meet their tax obligations. Our enforcement programs are aimed at deterring taxpayers inclined to evade their responsibilities while vigorously pursuing those who violate tax laws. Delivering these programs demands a secure and modernized infrastructure able to fairly, effectively, and efficiently collect taxes while minimizing taxpayer burden.

The IRS fiscal year 2008 President's budget request supports our agency-wide strategic plan as well as Treasury's compliance improvement strategy. These documents underscore the IRS' commitment to provide quality service to taxpayers while enforcing America's tax laws in a balanced manner. The IRS' strategic plan goals are:

—*Improve Taxpayer Service*.—Help people understand their tax obligations, making it easier for them to participate in the tax system;

—*Enhance Enforcement of the Tax Law*.—Ensure taxpayers meet their tax obligations, so that when Americans pay their taxes, they can be confident their neighbors and competitors are also doing the same; and

—*Modernize the IRS through its People, Processes and Technology*.—Strategically manage resources, associated business processes, and technology systems to effectively and efficiently meet service and enforcement strategic goals.

Budget Request

Our total budget request for fiscal year 2008 is for $11.1 billion in appropriated resources and represents a 4.7 percent increase over the recently enacted fiscal year 2007 Joint Resolution (JR) level of $10.6 billion.

The IRS' taxpayer service and enforcement activities are funded from three appropriations: Taxpayer Services (TS); Enforcement (ENF); and Operations Support (OS). The total fiscal year 2008 budget request for these three operating accounts is $10.8 billion supplemented by $180 million from user fee revenue, for a total operating level for these accounts of $10.9 billion—a 5.5 percent increase over the fiscal year 2007 operating level. As in fiscal year 2006 and fiscal year 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment, and I am pleased that the House and Senate Budget Committee marks for the 2008 Resolution include the full cap adjustment for this activity, recognizing the return on investment from these enforcement investments.

The budget also includes $282.1 million for Business Systems Modernization (BSM) and $15.2 million to administer the Health Insurance Tax Credit program—a 32.6 percent and 2.6 percent increase, respectively, over the fiscal year 2007 JR level.

Our fiscal year 2008 budget request provides $409.5 million for new initiatives and $340 million for the pay raise and other cost adjustments needed to sustain base operations.

The IRS' initiatives focus on the most significant needs for fiscal year 2008:

—$20.0 million to enhance taxpayer service through expanded volunteer tax assistance, increased funding for research to determine the most effective means to help taxpayers, and implementing new technology to improve taxpayer service;

—$246.4 million to expand enforcement activities targeted at improving compliance; and

—$143.1 million to improve the IRS' information technology (IT) infrastructure, including $62.1 million for the BSM program and $81.0 million for security and infrastructure enhancements.

This request also includes several program savings and efficiencies that reflect the IRS' aggressive efforts to identify and deploy work process and technology improvements that will benefit both taxpayer service and enforcement programs. Collectively, these cost savings total $120.0 million:

—*Taxpayer Service Efficiencies −$23.4 million/−527 FTE*.—These savings will result from operational efficiencies achieved through ongoing efforts to automate and enhance IRS taxpayer service programs' workload distribution, such as the implementation of automated issuance of Employer Identification Numbers and Correspondence Imaging System. Additional efficiencies and savings are expected to be achieved through the implementation of optimal service delivery initiatives identified by the Taxpayer Assistance Blueprint.

—*Enforcement Program Efficiencies −$60.2 million/−620 FTE*.—These savings will result from productivity and efficiency improvements realized through the implementation of enhanced technology and business processes, such as improved case selection tools and techniques. In addition, the completion of initial training and transition of the fiscal year 2006 new hires back to their front-line enforcement activities will result in additional efficiencies for the examination and collection programs.

—*Shared Service Support Efficiencies −$36.4 million/−37 FTE*.—These savings will result from several efforts, including the optimization and consolidation of space projects; implementation of cost-efficient government-wide contract support; and postage savings achieved through the consolidation, automation, and renegotiation of contract services for correspondence delivery.

A STRATEGIC PLAN TO IMPROVE VOLUNTARY COMPLIANCE AND REDUCE THE TAX GAP

The fiscal year 2008 budget supports our goal of improving voluntary compliance. The IRS has been working closely with the Office of Tax Policy at the Department of the Treasury to develop a strategic plan to achieve that goal. Key components of that goal and how they relate to the IRS budget are discussed below.

Enhancing Taxpayer Service

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the IRS.gov web site, Taxpayer Assistance Centers (TACs), Volunteer Income Tax Assistance (VITA) sites, and Tax Counseling for the Elderly (TCE) sites.

Assisting taxpayers with their tax questions before they file their returns reduces burdensome post-filing notices and other correspondence from the IRS, and proactively addresses inadvertent noncompliance.

The fiscal year 2008 budget request contains three significant taxpayer service initiatives. First, we are requesting $5 million to expand the VITA program, a significant component of our effort to support taxpayers eligible to claim the Earned Income Tax Credit. This taxpayer service initiative will help expand our volunteer return preparation, outreach and education, and asset building services to low-income, elderly, Limited English Proficient (LEP), and disabled taxpayers.

The budget also requests $5 million for additional resources to enhance our understanding of the role of the taxpayer service on compliance. This research will focus on understanding taxpayer burden, opportunities for enhanced service to help reduce errors made on returns, and the impact of service on overall levels of voluntary compliance.

Finally, the budget requests $10 million for four of the initiatives recommended by the Taxpayer Assistance Blueprint (TAB) Strategic Plan for taxpayer service. As part of the Blueprint effort, we conducted a comprehensive review of our current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the Blueprint, the funding for this initiative will implement the following telephone service and Web site interaction enhancements:

—Contact Analytics provides an analytical tool for evaluating contact center recordings for the purpose of improving business processes and lowering business costs, as well as improving customer service.

—Estimated Wait Time provides a real-time message that informs taxpayers about their expected wait time in queue, allowing them to make more informed decisions based on the status of their call and thus reducing taxpayer burden and increasing customer satisfaction.

—Expanded Portfolio of Tax Law Decision Support Tools enables taxpayers to conduct key word and natural language queries to get answers to tax law questions through the Frequently Asked Questions database accessed on IRS.gov, thereby steadily increasing customer satisfaction and operational savings.

—Spanish "Where's My Refund?" adds the ability to check refund status to the Spanish Web page on IRS.gov, enabling the Spanish-speaking community to re-

ceive the same level of customer service on the Web as available to the English Web page.

Continued technological advancements offer significant opportunities for the IRS to improve the efficiency and effectiveness of call center services. Web site enhancements are designed to maximize the value of IRS.gov, making the site taxpayers' first choice for obtaining the information and services required to comply with their tax obligations.

Improving Compliance Activities

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. We will continue to reengineer our examination and collection procedures to reduce cycle time, increase yield, and expand coverage. As part of our regular examination program, we are expanding the use of cost-efficient audit techniques first pioneered in the National Research Program (NRP).

We are also expanding our efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as nonfilers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

There are seven specific initiatives proposed in the fiscal year 2008 budget aimed at improving compliance. These initiatives provide:

—*$73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance*.—This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating persons who have evaded taxes for possible criminal referral. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year, once new hires reach full potential in fiscal year 2010.

—*$26.2 million for increasing compliance for large, multinational businesses*.—This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for noncompliance is significant in the reporting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 to 8.2 percent in fiscal year 2008, and produce over $74 million in additional annual enforcement revenue, once the new hires reach full potential in fiscal year 2010.

—*$28 million for expanded document matching in existing sites*.—This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. We believe the additional resources will result in an increase in AUR closures from 2.05 million in fiscal year 2007 to 2.64 million in fiscal year 2010. We expect $208 million of additional enforcement revenue per year, once the new hires reach full potential in fiscal year 2010. In addition, the budget requests $23.5 million to establish a new document matching program at our Kansas City campus. This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this new AUR site should result in over $183 million in additional enforcement revenue per year once the new hires reach full potential in fiscal year 2010.

—*$6.5 million to increase individual filing compliance*.—This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in fiscal year 2008 and produce $82 million of additional enforcement revenue per year, once the new hires reach full potential in fiscal year 2010.

—*$15 million to increase tax-exempt entity compliance*.—This enforcement initiative will deter abuse by entities under the purview of the Tax-Exempt and Governmental Entities Division (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE compliance contacts by 1,700 (six percent) and em-

ployee plan/exempt organization determinations closures by over 9,000 (eight percent) by fiscal year 2010.

—*$10 million for increased criminal tax investigations*.—This funding will help us aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which include an emphasis on the fraud referral program. Our robust pursuit of tax violators and the resulting publicity is aimed to foster deterrence and enhance voluntary compliance.

—*$41 million for conducting research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance*.—The data collected from these studies will enable the IRS to develop strategies to combat specific areas of noncompliance.

In addition to these initiatives, I would stress the importance of allowing us to continue with the private debt collection program. The Congress authorized the use of private collection agents (PCAs) in the American Jobs Creation Act of 2004. As we continue to debate the efficacy of this program, I want to take this opportunity to make a couple of points for purposes of our ongoing discussions.

One issue that has been debated is the relative efficiency of using PCAs versus IRS employees to collect the taxes owed. The most important question is not whether IRS employees or PCAs can do the job more efficiently, but rather whether PCAs collect money that would otherwise go uncollected. The IRS lacks the resources to pursue the relatively simple, geographically dispersed cases that are now being assigned to PCAs. It is not realistic to expect that the Congress is going to give the IRS an unlimited budget for enforcement, and if Congress provided the IRS additional enforcement resources, I believe those resources would be applied best by allocating them to more complex, higher priority cases that are not appropriate for PCAs.

The IRS continues to work with PCAs to ensure that the program is fair to taxpayers and respects taxpayer rights. The Treasury Inspector General for Tax Administration (TIGTA) agreed with that assessment. Earlier this month, TIGTA issued a report which noted that "IRS has taken proactive measures to effectively develop and implement the (PCA) Program."

The report said that we had taken the appropriate steps to ensure contractor employees received sufficient and adequate training on applicable laws and regulations before allowing them access to Federal tax information. This process included providing contractors with an orientation and overview of the training required and conducting an onsite assessment of the contractor training.

TIGTA also recognized that we had required all contractor employees assigned to the Program contract, or who have access to Federal tax information, to undergo background investigations. We granted either interim or final approval of background investigations for each employee working on the contract at the time of our review.

We currently estimate that between now and fiscal year 2017, our partnership with PCAs will result in approximately 2.9 million delinquent cases receiving treatment that would otherwise have gone unworked. This partnership will help reduce the backlog in outstanding tax liabilities, which has grown by 118 percent over the last 12 years.

From September 7, 2006, when cases were first assigned to PCAs, through March 22, 2007 PCAs collected $19.47 million in gross revenue. We estimate that cases worked by PCAs will generate estimated gross revenue of $1.4 billion through fiscal year 2017.

Another reason to continue to use this tool is to evaluate whether we in the public sector can learn anything from these PCAs that will enable us to do our jobs better. Particularly over the last 20 years, government agencies at all levels have adopted many practices and ways of doing business that have been pioneered in the private sector. One need look no further than the vastly expanded use by the government of the Internet in providing services to the public as an example of a practice that was pioneered in the private sector, but adopted quickly and effectively by the government. We should not remove PCAs as a tool for addressing the problem before we have an opportunity to evaluate the potential of this initiative to help improve compliance, and perhaps even to show the government how to be more effective in its own efforts.

Reducing Opportunities for Evasion

The IRS is already aggressively pursuing enforcement initiatives designed to improve compliance and reduce opportunities for evasion. As I pointed out earlier, these efforts have produced a steady climb in enforcement revenues since 2001, as

well as an increase in both the number of examinations and the coverage rate in virtually every major category.

In the budget request, the Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties in the following ways:

—*Expand information reporting*.—Specific information reporting proposals would:
  —Require information reporting on payments to corporations;
  —Require basis reporting on sales of securities;
  —Expand broker information reporting;
  —Require information reporting on merchant payment card reimbursements;
  —Require a certified taxpayer identification number (TIN) from non-employee service providers;
  —Require increased information reporting for certain government payments for property and services; and
  —Increase information return penalties.

—*Improve compliance by businesses*.—Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:
  —Require electronic filing by certain large businesses;
  —Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes; and
  —Amend collection due process procedures applicable to employment tax liabilities.

—*Strengthen tax administration*.—The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:
  —Expand IRS access to information in the National Directory of New Hires database;
  —Permit the IRS to disclose to prison officials return information about tax violations; and
  —Make repeated failure to file a tax return a felony.

—*Expand penalties*.—Penalties play an important role in discouraging intentional noncompliance. Specific proposals to expand penalties would:
  —Expand preparer penalties;
  —Impose a penalty on failure to comply with electronic filing requirements; and
  —Create an erroneous refund claim penalty.

The Administration also has four proposals relating to IRS administrative reforms.

The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.

The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.

The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding $50,000. This proposal requires that the Secretary of the Treasury establish standards to determine when an opinion is appropriate.

The fourth proposal modifies the way that Financial Management Services (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to add the fee to the liability being recovered, thereby shifting the cost of collection to the delinquent taxpayer. The offset amount would be included as part of the 15-percent limit on continuous levies against income.

Collectively, these proposals should generate $29.5 billion in revenue over 10 years. The proposed budget provides $23 million to begin implementation of these initiatives. This funding will allow the purchase of software and the modifications to IRS information technology systems necessary to implement these legislative proposals.

Enhancing Research

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. Historically, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of line-by-line audits of random samples of returns. This study provided us with information on compliance trends and allowed us to update audit selection formulas. However, this method of data gathering was extremely burdensome on the taxpayers who were forced

to participate. One former IRS Commissioner noted that the TCMP audits were akin to having an autopsy without the benefit of death. As a result of concerns raised by taxpayers, Congress, and other stakeholders, the last TCMP audits were done for Tax Year (TY) 1988.

We have conducted several much narrower studies since then, but nothing that would give us a comprehensive perspective on the overall tax gap. As a result, until the recent NRP data, all of our subsequent estimates of the tax gap were rough projections that basically assumed no change in compliance rates among the major tax gap components; the magnitude of these projections reflected growth in tax receipts in these major categories.

The National Research Program (NRP), which we have used to estimate our most recent tax gap updates, provides us a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. We used a focused, statistical selection process that resulted in the selection of approximately 46,000 individual returns for TY 2001. This population sample was less than previous compliance studies, even though the population of individual tax returns had grown over time. Like the compliance studies of the past, the NRP was designed to allow us to estimate the overall extent of reporting compliance among individual income tax filers, and to update our audit selection formulas. It also introduced several innovations designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The NRP provided updated estimates for determining the sources of noncompliance. The IRS also uses the NRP findings to better target examinations and other compliance activities, thus increasing the dollar-per-case yield and reducing "no change" audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

Almost as important as understanding what the NRP research provides is to understand its limitations. The focus of the first NRP reporting compliance study was on individual income tax returns. It did not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. Our estimates of compliance with taxes other than the individual income tax are still based on projections that assume constant compliance behavior among those major tax gap components, since the most recent compliance estimates were compiled (i.e., for TY 1988 or earlier).

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target resources, effectively provide the best service possible, and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts.

The fiscal year 2008 budget request includes funds for two significant research initiatives. First, the budget requests $41 million to improve compliance estimates, measures, and detection of noncompliance. This funding will allow research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance. Unlike in the past, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This approach will provide fresh compliance estimates each year, and by combining samples over several years, will provide a regular update to the larger sample size needed to keep our targeting systems and compliance estimates up to date.

The second initiative funded by the request is to research the effect of service on taxpayer compliance. The budget requests $5 million for this project, which will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:

—Meeting taxpayer needs by providing the right channel of communication;
—Better understanding taxpayer burden;
—Understanding taxpayer needs through the errors they make; and
—Researching the impact of service on overall levels of voluntary compliance.

Continuing Improvements in Information Technology

Tax administration in the twenty-first century requires improved IRS information technology (IT). We are committed to continuing to make improvements in technology and the fiscal year 2008 budget request reflects that commitment. The request includes $81 million to improve the IRS' information technology infrastructure. Sixty million dollars of this amount is requested to upgrade critical IT infrastructure, addressing the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in fis-

cal year 2008 include procuring and replacing desktop computers, automated call distributor hardware, mission critical servers, and Wide Area Network/Local Area Network routers and switches.

The other $21 million will be used to enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Finally, the fiscal year 2008 budget request includes a total of $282.1 million to continue the development and deployment of the IRS Business Systems Modernization (BSM) program in line with the recommendations identified in the IRS Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

The development of the CADE (Customer Account Data Engine) and AMS (Account Management Services) systems is the heart of the IT modernization of the IRS. The combination of these two systems working together will enable the IRS to process tax returns and deal with taxpayer issues in a near real-time manner. Our objective is that the IRS operate similarly to what one expects from one's bank—account transactions occurring during the business day will be posted and available by the next business day. In addition, AMS will enable the IRS representatives who work with taxpayers to have access to all the information regarding that taxpayer, including electronic access to tax return data, and electronic copies of correspondence. Equipped with such comprehensive and up-to-date information, our representatives will be in a much better position to help taxpayers resolve their issues.

MeF is the future of electronic filing. It provides a standard data format for all electronic tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns, resulting in a quicker acknowledgement of the filing to the taxpayer or their representative. In fiscal year 2007, the IRS will start development and implementation of the 1040 on the MeF platform.

CSP will provide funding for new portals, which are technology platforms that meet many IRS business needs through Web-based front-ends, and provide secure access to data, applications, and services. The portals are mission-critical components of the enterprise infrastructure required to support key business processes and compliance initiatives.

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, the business community, and government, but also contribute to operational improvements and efficiencies within the IRS.

OTHER ISSUES

In recent weeks, there has been much publicity over identity theft and the loss of IRS laptops. Please allow me to bring you up to date on these issues.

Identity Theft

Taxpayer and employee privacy is a foremost concern of the IRS. We are charged with protecting confidential information about every taxpayer. In recognition of this responsibility, we continue to update our systems and our training so that employees who have access to sensitive information are aware of the steps they must take to prevent that information from being compromised.

This job has never been tougher. According to the FBI, identity theft is one of the fastest growing white collar crimes. There has been a 4,600 percent increase in computer crime since 1997. Nearly 10 million Americans each year are affected by identity theft, according to the Federal Trade Commission (FTC). Deloitte-Touche has reported that financial institutions and U.S. banks have also experienced a significant increase in the number of computer based attacks and attempted intrusions into financial systems.

The FTC also reports, "About 90 percent of business record thefts involve payroll or employment records, while only about 10 percent are generated from customer lists." These business record thefts also include job applications, personnel records, health insurance and benefits records, and payroll related tax documents that pro-

vide personal information that identity thieves use to steal employees' identities. While most identity theft is use of consumer's personal information to make purchases, almost 1.5 million victims indicated that their personal information was misused in non-financial ways to obtain government documents or tax forms.

Through our Automated Underreporter Program (AUR), we see firsthand potential instances of identity theft. The AUR matches W–2s for the same SSN to ensure that the taxpayer has reported all sources of income. If identity theft has occurred the SSN may have been used with multiple employers who have issued multiple W–2s for the SSN. In Tax Year (TY) 2004, the latest year for which we have data, there were 16,152 identity theft claims made through the AUR program. This level is far less than the 30,639 cases in TY 2002, but a few more than the 12,618 claimed in TY 2003. In these cases, if the affected taxpayer provides the necessary documentation on an identity theft claim, the income in question will not result in an additional assessment.

We have tried to take the initiative in proactively analyzing processes to identify areas of vulnerability, and in educating taxpayers and employees about identity theft. We have teamed with other federal agencies, such as the Federal Trade Commission (FTC), the Department of Justice (DOJ) and the Social Security Administration (SSA) to address identity theft crime. Treasury was also a member of the Identity Theft Task Force, created by executive order in May 2006, and which recently submitted to the President an identity theft plan entitled "Combating Identity Theft: A Strategic Plan".

In 2005 we began an aggressive strategy to research and address this growing problem. We established an Identity Theft Program Office charged with implementing the IRS' policy on identity theft. This policy requires the IRS to take the necessary steps to provide assistance to victims of identity theft within the scope of their official duties. Our Identity Theft Program Office works with offices throughout the IRS to implement the agencies' Identity Theft Enterprise Strategy comprised of three components—Outreach, Prevention and Victim Assistance.

Outreach

The IRS has undertaken several outreach initiatives to provide taxpayers, employees, and other stakeholders with the information they need to proactively prevent and resolve identity theft issues. For example, the IRS:

—Revised the most widely used documents, such as the Form 1040 instructions and Publication 17, Your Federal Income Tax, to include information about identity theft.

—Launched an identity theft website on IRS.gov to provide victims with updated information and links to SSA and FTC and with information on how to contact the Taxpayer Advocate.

—Participated with Department of Treasury and the SSA in a multi-agency panel discussion on identity theft, which was held at the IRS nationwide tax forums in 2006 that reached approximately 30,000 tax preparers.

—Developed an internal web communication tool to alert IRS employees to issues of identity theft.

—Lead a multi-agency working group (Treasury, FTC, SSA, and Homeland Security) with a goal of providing consistent information and services to victims, consistent with recommendations being made by the President through the Identity Theft Task Force.

—Partnered with the Treasury Inspector General for Tax Administration (TIGTA) to develop and promote a consistent message to inform taxpayers that the IRS does not communicate with taxpayers via e-mail, with the goal of reducing the number of identity thefts accomplished by "phishing."

—Jointly with TIGTA published an e-mail address on IRS.gov to serve as a repository for the fraudulent emails so they could be tracked to the source and destroyed.

Victim Assistance

We recognize that outreach alone is not enough and that we also must be prepared to assist victims when identity theft occurs. With respect to the victim assistance prong of the Enterprise Strategy:

—The IRS established a new identity theft policy that provides for consistent procedures across its functions to ensure timely resolution of identity theft issues affecting taxpayer accounts.

—The IRS has developed new standards for documentation required from taxpayers to validate the identity of the taxpayer, address, and the fact of the identity theft. These documentation standards are consistent with those required by FTC and SSA.

—The IRS has worked closely with SSA to reduce the time required to resolve cases where more than one taxpayer uses the same SSN on a tax return (called the Scrambled SSN process). The average timeframe to resolve the case is now approximately 10 months compared to 18 months previously. As of March 24, 2007, the current scrambled SSN inventory count is approximately 5,000 cases. Approximately 38,000 cases have been referred to SSA in 2003–2006.

—The IRS updated its processes and notices to help taxpayers whose name and SSN were used by an identity thief for employment purposes. When the IRS matches an identity thief's W–2 information with a legitimate taxpayer's income tax return, the IRS sends the taxpayer a notice regarding the under-reported income. This notification is often the first time the victim is aware of the identity theft. To aid these victims of identity theft, the under-reporter notices were updated with specific instructions on the type of documents and information needed to validate the identity theft cases.

—The IRS is taking additional steps to reduce taxpayer burden associated with identity theft. By January 2008, the IRS will implement a new Service-wide identity theft indicator that will be placed on a taxpayer's account upon the authentication of identity theft. Once the new process is fully deployed, taxpayers should have to provide identity theft authentication only one time, and the IRS will be able to reject returns which do not appear to be from the legitimate owner of the SSN.

Prevention

There are three types of identity theft crimes in tax administration: refund crimes, employment and income diversion.

—Refund crimes are perpetrated by criminals who use another person's tax information to fake a return and steal a refund. The Refund Crimes Unit of the IRS' Criminal Investigation Division identifies those returns through the Questionable Refund program.

—The IRS is developing several initiatives to reduce the incidence of theft related to employment, such as working with SSA to explore initiatives to improve the accuracy of SSN reporting.

—Individuals who make false identity claims to underreport income will face additional tax and penalties, as will preparers who promote such schemes.

To augment the IRS Identity Theft Enterprise Strategy composed of outreach, assistance, and prevention, the IRS initiated a Service-wide Identity Theft Risk Assessment to qualify and quantify existing threats and vulnerabilities related to IRS processes that could directly or indirectly facilitate identity theft and/or taxpayer burden. As an output of this risk assessment, the IRS developed (and has began the implementation of) targeted remediation strategies designed to address the identified threats and vulnerabilities.

Where justified, we have referred cases of identity theft to our Criminal Investigation (CI) unit. In the past two years, CI has successfully investigated a number of cases that were successfully prosecuted in which identity theft has led to tax fraud. Just last month, two women from Ohio were sentenced to 63 and 188 months, respectively, and ordered to pay $300,000 in restitution for perpetuating an identity theft scheme. As part of this scheme, the women claimed nearly $114,000 in tax refunds to which they were not entitled.

Last November, a Florida man was sentenced to 63 months in prison to be followed by three years of supervised release for making false claims against the IRS and for identity theft. He was also ordered to pay a personal money judgment of $152,171, and to pay $152,171 in restitution to the IRS. To carry out this scheme, the man used the Internet to obtain personal information, including names and dates of birth, for at least 150 Florida inmates.

We are also continuing to review ways we can protect our employees from identity theft. The IRS Office of Privacy is identifying ways to reduce or eliminate the Service's use of employee SSNs in certain applications to minimize the risk of improper use. We are closely coupling privacy and identity theft protections with the agency security program, so that when we do need to collect SSNs—either employee or citizen, we can ensure that they are adequately protected within our systems.

The main focus for the annual IRS' Security Awareness Week, last November, was "Identity Theft/Fraud." We focused activities on raising awareness and making employees aware of their responsibilities.

While research shows that the IRS has one of the lowest rates of identity theft in all the Federal government, we still take this situation very seriously. We have made significant progress, but additional work remains—including implementing additional mediation strategies and conducting in-depth analyses of the remaining high-priority processes.

Laptop Security

Every year, the IRS processes over $2 trillion in revenues to fund the U.S. operating budget. Although the majority of this is collected in an automated banking system throughout the year, about $300 billion is collected through 8 IRS campuses where taxpayers send their tax returns for processing. We house computing systems that hold data on all taxpayers, and also process enormous volumes of paper data in our more than 500 offices across the country. We have more than 82,000 full time and 12,000 part-time employees across the United States. Our workforce is highly mobile, as revenue agents and officers are often in the field working directly with taxpayers.

IRS computers, networks, and databases are protected by multiple layers of security, including modern security technology devices such as firewalls, encrypted communication links, and automatic intrusion detection devices.

The IRS is one of the few government agencies operating its own 24/7 computer security incident response center (CSIRC) to monitor IRS computer and network security, and to collect and follow up on any security incidents. The IRS' CSIRC works in close coordination with the Treasury Department and the Department of Homeland Security's CSIRCs and the US–CERT incident reporting center.

As I mentioned earlier, the fiscal year 2008 budget for IRS proposes $21 million to be used to enhance CSIRC and the network infrastructure security. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

The IRS has always had policy guidance in place requiring employees to protect taxpayer information and other personal and private data. Protection of taxpayer information is emphasized and stressed in all employee orientation and refresher training as one of the Service's highest priorities.

Prior to January 2007, all IRS laptops included encryption tools that IRS employees were required to use to encrypt all sensitive information. We recognize that this previous generation of encryption tools may have been technically complex and challenging for many employees and as a result some may have not have done the proper encryption. Therefore, we have recently completed installation of an automatic full disk encryption product on all IRS laptops that automatically encrypts all data on the laptop, without requiring any employee action. We have tested this encryption system and certified that it meets mandatory standards. We have also provided physical security locks for all IRS laptops.

IRS employees have reported the loss or theft of over 500 laptop computers over the last five years. Prior to May 2006, these reports primarily focused on reporting the theft or loss of IT equipment. Given the heightened awareness across the Federal Government in 2006 to the protection of sensitive personally identifiable information (PII), all government agencies now are focused more on the reporting of any sensitive information that may have been lost when a laptop is lost or stolen.

The IRS laptop losses were reported to TIGTA, which investigated these incidents and provided reports back to IRS management. We recovered very few devices, as they are quickly re-sold.

We are also working with our Federal and State partners with whom we share information to implement encryption solutions on data tapes. The encryption solutions are planned to be completed by October 1, 2007. In the interim, the IRS is using special security shipping containers and courier services to ensure that tapes shipped from IRS are protected. Recipients of the data are subject to implementing specific safeguards and complying with published standards for the protection of the data. Appropriate documentation is required for the transport of the tapes.

As the President's Taskforce on Identity Theft recommended, the Office of Management and Budget (OMB) is working closely with all agencies, including the IRS, to develop policy guidance for notification in instances where an individual's personally identifiable information has been compromised. The IRS has everything in place to comply with this new policy. We have reviewed all incidents, and there are a few that likely will require follow up (notification).

SUMMARY

One of the questions that the IRS is asked frequently is how much money, beyond the budget request, we could use productively. My honest answer to that question

is that while I want Congress to appropriate every cent that has been requested, our ability to absorb additional funding beyond that amount is limited by our capacity to hire and train new personnel.

The fiscal year 2008 budget request includes significant increases for IRS enforcement efforts. Fully funding that request will help us make progress in greatly improving voluntary compliance. Based on our analysis, covering the most recent 11 years of collection experience, we estimate that every dollar we have spent on enforcement has generated a direct return of an average of four dollars in increased revenue to the Federal Treasury. This return can be expected to occur when the full productive benefit of the investment is realized.

This direct return on investment does not consider the indirect effect of increased enforcement activities in deterring taxpayers who are considering engaging in noncompliant behavior. Econometric estimates of the indirect effects indicate a significant impact from increased enforcement activities. Stated another way, taxpayers who see us enforcing the law against their friends, neighbors, or competitors are more likely to comply voluntarily and not risk the chance that we might audit them. We do not measure this indirect impact, but research suggests that it could be as much as three times or more the direct impact on revenue.

We also believe that dollars spent on taxpayer service have a positive impact on voluntary compliance. The complexity of complying with the nation's current tax system is a significant contributor to the tax gap, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of improving voluntary compliance. To this end, the IRS remains committed to a balanced program assisting taxpayers in both understanding the tax law and remitting the proper amount of tax.

In addition, the President's fiscal year 2008 budget request contains a number of legislative proposals that provide additional tools for the IRS to enforce the existing tax law. Perhaps the most critical of these tools is greater third party reporting. An analysis of the data from the National Research Program of TY 2001individual income tax returns leads to one very obvious conclusion. Compliance is much higher in those areas where there is third party reporting. For example, only 1.2 percent of wages reported on Forms W–2 are underreported. This compares to a 53.9 percent underreporting rate for income subject to little or no third party reporting.

The fiscal year 2008 budget request asks Congress to expand information reporting to include additional sources of income and make other statutory changes to improve compliance. These legislative proposals are intended to improve tax compliance with minimum taxpayer burden. When implemented, it is estimated that these proposals will generate $29.5 billion over ten years.

I appreciate the opportunity to testify this morning, and I will be happy to respond to any questions that Members of the Committee may have.

Senator DURBIN. Mr. George.

STATEMENT OF RUSSELL GEORGE

Mr. GEORGE. Thank you, Mr. Chairman. Mr. Chairman, thank you for the invitation to appear to discuss the Internal Revenue Service's fiscal year 2008 proposed budget. At your request, my testimony will also address the 2007 tax filing season as well as TIGTA's 2008 budget request.

The IRS's total budget request of approximately $11.4 billion includes funding for programs that pose significant long-term and short-term challenges to the service. Some of these concerns include improving taxpayer services, enhancing enforcement of the tax laws, as well as the IRS's modernization efforts, all while attempting to ensure their security. The IRS is making progress in some of these areas. However, several concerns remain.

For example, in the area of taxpayer services the IRS has indicated that it wants to expand its voluntary income tax assistance program. However, during the 2007 filing season our auditors found that only 56 percent of the test tax returns we used to help test the system were accurately prepared by the volunteers. While this is an improvement over the test TIGTA conducted in 2006, it

is unacceptable that taxpayers who use this IRS-sanctioned service have a slightly better than 50–50 chance that their tax returns will be accurately prepared. TIGTA believes that taxpayers would be better served if the resources were allocated in a way to allow these programs to achieve better results.

Another area of concern is the IRS's implementation of the taxpayer assistance blueprint. The initiatives in this document focus on services that support the needs of individual taxpayers. TIGTA reviewed the development of the first phase of the blueprint and found that most but not all the information it contained was accurate. Our review concluded that the inaccurate information did not affect the service's improvement themes. However, we are concerned that if these problems were to continue there is a heightened risk of bad data leading to bad choices.

The 2008 IRS budget request also includes approximately $62 million to develop and deploy the IRS's business systems modernization program. This increase would allow the service to continue projects such as the customer account data engine (CADE), which is the foundation of the IRS's modernization efforts. Referred to as CADE, it will replace the antiquated master file system, which is based on technology from the 1960s.

The IRS has estimated that CADE would process 33 million tax returns during the 2007 filing season. However, due to delays in implementing the newest release of the project, the service now estimates that the system will process fewer than 20 million returns this season. While this delay is a short-term concern, there has been a pattern of deferring CADE requirements and missing deployment dates. Allowing this pattern to continue could undermine the long-term success of the program.

It is widely recognized that continued emphasis on enforcement is needed if we are to successfully narrow the tax gap. Indeed, a significant portion of the IRS's proposed funding for fiscal year 2008 is for enhanced enforcement personnel and an initiative to improve compliance, estimates and measures. Although having new information about individual taxpayers is useful as they are the largest taxpaying segment, there is no current information available about employment, small and large corporations, and other compliance segments. Without firm plans to study these segments, the current tax gap estimate is an incomplete picture.

Despite the challenges of implementing last-minute tax law changes, the 2007 filing season appears to be progressing without major problems. The number of electronically filed returns has increased, as has use of the IRS's Internet site and many of its other customer services. However, I have raised concerns about the IRS's telephone excise tax refund program conducted this year. Many taxpayers have not claimed the one-time refund even though the IRS simplified the process and publicized it. In addition, some taxpayers have submitted highly questionable refund claims which did not garner further IRS scrutiny.

Mr. Chairman, as requested, I have included in my written statement the challenges confronting TIGTA, many of which are similar to those of other Federal agencies. Our workload, labor costs and rent continue to increase. However, due to budgetary constraints

our staffing level over the last several years declined by over 12 percent.

PREPARED STATEMENT

Mr. Chairman, members of the subcommittee, I hope my discussion of some of the fiscal year 2008 budget and 2007 tax filing season issues will assist you in your consideration of the IRS's appropriations. I would be happy to answer questions at the appropriate time.

Senator DURBIN. Thanks, Mr. George.

[The statement follows:]

PREPARED STATEMENT OF J. RUSSELL GEORGE

Chairman Durbin, Ranking Member Brownback, and Members of the Subcommittee, I thank you for the opportunity to testify today. My comments will focus on the Internal Revenue Service's (IRS or Service) fiscal year 2008 budget, the 2007 Filing Season, and, at your request, the Treasury Inspector General for Tax Administration's (TIGTA) fiscal year 2008 budget request. The IRS administers America's tax laws and collects approximately 95 percent of the revenues that fund the Federal Government. It is therefore important to identify the resources required to support the IRS' role as steward of the Nation's tax administration system.

OVERVIEW OF THE IRS' FISCAL YEAR 2008 BUDGET REQUEST

The major component of the Department of the Treasury, IRS has primary responsibility for administering the Federal tax system. Since this is a self-assessment system, almost everything the Service does is in some way related to fostering voluntary compliance with tax laws. It provides taxpayer service programs that help millions of taxpayers to understand and meet their tax obligations. The IRS' resources also provide for enforcement programs aimed at deterring taxpayers who are inclined to evade their responsibilities, and vigorously pursuing those who violate tax laws.

The IRS must strive to enforce the tax laws fairly and efficiently while balancing service and education to promote voluntary compliance and reduce taxpayer burden. To accomplish these efforts, the proposed fiscal year 2008 IRS budget requests resources of approximately $11.4 billion. Included in this amount are approximately $11.1 billion in direct appropriations, $133.5 million from reimbursable programs, and $180 million from user fees. The direct appropriation is approximately a $657 million increase, or 6.3 percent, over the budget provided by the fiscal year 2007 Continuing Resolution. Highlights of the increase include: $131 million for taxpayer service initiatives; $440 million for enforcement initiatives; $282 million for the IRS' Business Systems Modernization program; and $60 million for critical Information Technology (IT) infrastructure upgrades (included in the enforcement and taxpayer service totals above).

The fiscal year 2008 budget also includes funding to implement the Department of the Treasury's (Department) tax gap strategy. In September 2006, the Department published a comprehensive plan to improve tax compliance. Additionally, delivery of IRS programs demands a secure and modernized infrastructure capable of fairly, effectively, and efficiently collecting taxes while minimizing taxpayer burden. The fiscal year 2008 budget request supports the Service's five-year strategic plan and the Department's compliance improvement strategy. The IRS' strategic plan goals are to improve taxpayer service, enhance enforcement of the tax law, and modernize the Service through its people, processes and technology.

IMPROVE TAXPAYER SERVICE

The fiscal year 2008 budget increases funding for taxpayer service by $131 million. This includes $56 million for new service initiatives and $75 million for cost increases. IRS employees represent the face of the Federal Government to more American citizens than most other government agencies. The request includes $20 million to enhance taxpayer service through expanded volunteer income tax assistance, increased funding for research, and implementing new technology to improve taxpayer service.

TIGTA is concerned about the taxpayer service initiative to expand the IRS' volunteer return preparation. The IRS is requesting an additional $5 million and 46

Full Time Equivalents (FTE)[1] to expand the VITA Program. According to the IRS, this will help "expand the IRS' volunteer return preparation, outreach and education, and asset building services to low-income, elderly, limited English proficient, and disabled taxpayers."[2]

TIGTA believes the IRS should proceed cautiously in its expansion efforts, given the importance of the accuracy of tax return preparation. TIGTA is reviewing the IRS' Volunteer Income Tax Assistance (VITA) program as part of our 2007 Filing Season oversight activities. As of April 12, 2007, TIGTA has had 39 tax returns prepared with a 56 percent accuracy rate. While the 2007 Filing Season accuracy rate is an improvement compared to the 39 percent accuracy rate reported for the 2006 Filing Season, taxpayers still have just a 1 in 2 chance of having their tax returns accurately prepared by VITA program volunteers.[3] TIGTA's observations are that volunteers did not always use the tools and information available to them when preparing returns. There is the potential that these resources might be put to better use by funding IRS assistance programs that achieve better results.

The fiscal year 2008 IRS budget request also includes $10 million to implement the Taxpayer Assistance Blueprint (TAB). The TAB initiative provides additional resources for new research on the needs of taxpayers in order to better understand the role of taxpayer service on compliance. The research will focus on meeting taxpayer needs by providing the right channel of communication; providing a better understanding of taxpayer burden; understanding taxpayer needs through the errors they make; and evaluating the impact of service on overall levels of voluntary compliance.

In July 2005, Congress issued a conference report requesting that the IRS develop a five-year plan for taxpayer service activities.[4] In November 2005, the IRS was asked to provide the report to the House and Senate by April 14, 2006.[5] The Senate committee report stated that the plan should outline the services the IRS should provide to improve service to taxpayers; detail how the IRS plans to meet the service needs on a geographic basis; and, address how the IRS would improve taxpayer service based on reliable data. The plan was to be developed with the IRS Oversight Board[6] and the National Taxpayer Advocate.

The IRS conducted a comprehensive review of its current portfolio of services to individual taxpayers to determine which services should be provided and improved. Based on the findings of the TAB review, the funding for this initiative would implement telephone service and Web site enhancements.

To satisfy the report submission date of April 14, 2006, the IRS designed the TAB as a two-phased process. The TAB Phase I report identified strategic improvement themes by researching IRS service relative to taxpayers' needs and preferences. The TAB Phase II report will validate those themes through further research of taxpayers' service preferences and will develop the five-year plan for service delivery. The 2006 TAB Phase I report, issued April 24, 2006, presented strategic themes to improve education and awareness; optimize partner services; elevate self-service options; improve and expand training and services; and, develop performance and outcome goals and metrics.

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[1] A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For fiscal year 2005, 1 FTE was equal to 2,088 hours.

[2] *U.S. Department of the Treasury Fiscal Year 2008 Budget in Brief*, February 5, 2007, page 62.

[3] The population of VITA sites is not fixed, and VITA sites open and close throughout the filing season. Therefore, TIGTA could not determine a total population of VITA sites and could not select a statistical sample from which to project results. The filing season is the period from January through mid-April when most individual income tax returns are filed.

[4] United States Congress, Senate Report 109–109. Transportation, Treasury, The Judiciary, Housing and Urban Development, and Related Agencies Appropriations Bill, 2006: Internal Revenue Service, Processing, Assistance and Management, Committee Recommendation, July 26, 2005.

[5] United States Congress, Conference Report 109–307. Joint Explanatory Statement of the Committee of Conference: Internal Revenue Service, Processing Assistance, and Management (Including Rescission of Funds), November 14, 2005.

[6] A nine-member independent body charged with overseeing the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction.

The focus of the TAB initiative is on services that support the needs of individual filers who file or should file Form 1040 series tax returns.[7] TIGTA reviewed the development of the TAB, and found that while the majority of the information it contains is accurate, some of the information is not accurate. The compilation of some of the data could adversely affect IRS management decisions. For example, TIGTA noted inaccuracies in the report related to changes in Taxpayer Assistance Center visits and the number of telephone calls answered. Overall, TIGTA concluded that information found to be inaccurate and inconsistent did not affect the IRS' strategic improvement themes.[8]

The inaccuracies and inconsistencies resulted primarily from the IRS not having an effective process to ensure that all statements in the TAB Phase I report correctly reflected the results of its research and data analyses. According to IRS officials, actions were taken to improve the process for the validation of information included in the TAB Phase II report. The actions included an in-depth review to locate and verify the accuracy of all data in the report. Verifications were also performed to ensure the accuracy of statements and representations included in the report. Based on these actions, TIGTA did not make recommendations on the TAB Phase I report.

If these inconsistencies exist in the Phase II report, the risk increases that the IRS will draw inaccurate conclusions based on erroneous data.[9] TIGTA was unable to determine the impact the inconsistencies may have on results outlined in the TAB Phase II report because it was not available for review. The IRS did not provide TIGTA with a copy of the report before it was officially issued.

2007 FILING SEASON

The 2007 Filing Season appears to be progressing without major problems. As of April 28, 2007, the IRS reported that it had received more than 125 million individual tax returns. Of those returns, more than 76 million (61 percent) were filed electronically. The number of electronically filed tax returns is 8.7 percent higher than at the same time last year. The IRS has issued almost 92 million refunds for a total of $209 billion.

While the IRS has seen a growth in the number of electronically filed tax returns so far this filing season, the number of Free File returns is down slightly. As of April 28, 2007, the IRS received approximately 3.7 million tax returns through the Free File Program, compared to approximately 3.8 million returns at the same time last year.

Over the past few years, TIGTA audits have shown that the IRS has improved customer assistance in its face-to-face, toll-free telephone, tax-return processing, and electronic services, including the IRS public Internet site (www.IRS.gov).[10]

Use of IRS.gov is up with over 133 million visits to the Web site, while the Taxpayer Assistance Centers (TACs) have received 2.2 million walk-in contacts, approximately 3 percent more than this time last year. TIGTA made anonymous visits to TACs to determine if taxpayers are receiving quality service, including correct answers to their questions. The assistor level of service in the IRS' toll-free operations was higher than was planned, as the IRS answered 14.6 million calls. The IRS also completed 17.5 million automated calls; a decrease of 5.4 percent from last year's 18.5 million.

Telephone Excise Tax Refunds

A concern so far this filing season has been the IRS' telephone excise tax refund program. The IRS estimated that between 151 million and 189 million people would seek this one-time refund, including many without a filing requirement. Taxpayers may claim either a standard refund amount or an itemized refund for the actual excise tax they paid on their telephone bills. By using the standard amounts individuals do not have to assemble 41 months of telephone bills to determine the amount of their refund. Requesting one of the standard amounts requires the completion of only one additional line on the tax return.

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[7] Form 1040 series tax returns include any IRS tax forms that begin with "1040" such as U.S. Individual Income Tax Return (Form 1040), U.S. Individual Income Tax Return (Form 1040–A), and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040–EZ).

[8] Draft Audit Report—*The Strategic Improvement Themes in the Taxpayer Assistance Blueprint Phase I Report Appear to Be Sound; However, There Were Some Inaccurate Data in the Report* (TIGTA Audit Number 200740012, dated April 13, 2007).

[9] The TAB Phase II report was issued the week of April 9, 2007, after completion of TIGTA's TAB Phase I review. TIGTA has begun a review and evaluation of the TAB Phase II report and will include testing of the quality review process.

[10] *Taxpayer Service Is Improving, but Challenges Continue in Meeting Expectations* (TIGTA Reference Number 2006–40–052, dated February 2006).

The standard amounts developed by the IRS have proved to be very effective. Through the week ending April 21, 2007, IRS records indicate that 99.5 percent of telephone excise tax refund claims were filed for standard amounts. However, over 28.5 percent of the total number of individual tax returns filed contained no claim for a telephone excise tax refund, which indicates that many taxpayers may not be aware of their opportunity to claim this refund. TIGTA is continuing to monitor the steps the IRS is taking to address this issue.[11]

TIGTA raised concerns to the IRS regarding the processing of returns claiming telephone excise tax refunds for non-standard amounts. Specifically, thresholds were set too high for the IRS to take action when taxpayers:

—claimed refunds for more than the standard amounts but did not provide the required Form 8913, Credit for Federal Telephone Excise Tax Paid, to substantiate their claims.

—claimed one amount on their tax return and a different amount on their Form 8913.

When TIGTA reported these issues, the IRS took immediate steps to address the problems.

TIGTA has also raised concerns with the IRS' implementation of its compliance strategy related to these claims. In TIGTA's opinion, the dollar threshold used to identify potentially egregious claims is set too high. As of April 28, 2007, over 51,000 such claims had been received that did not meet the IRS' criteria for review. The amount of telephone excise tax refunds on these claims totaled more than $44.1 million. Over 38,000 of these claims were on tax returns with no Schedules C, E or F,[12] which makes the claimed amounts even more questionable. If each of the 38,000 returns claimed the standard excise tax refund amount of $60, the total refunds would equal $2.3 million. While small business claims for actual excise taxes paid would likely be greater than the standard amount, the lack of corresponding Schedules C, E or F raises questions about the claims.

The IRS reported that it set the threshold high because its examination resources are limited, and because it believes that examinations of returns claiming the Earned Income Credit (EITC)[13] and other discretionary examinations will result in higher assessment rates than examinations of the telephone excise tax refund claims. TIGTA recommended that the IRS re-examine all options at its disposal to address significantly more inappropriate telephone excise tax refund claims. The IRS responded to TIGTA's concerns, stating that it did not plan to make adjustments to the threshold amounts.

TIGTA has also shared concerns about paid preparers and the telephone excise tax refund with the IRS. As of April 28, 2007, one paid preparer had filed over 1,500 returns with telephone excise tax refund claims exceeding the standard amounts. Only eight of this preparer's claims have exceeded the Service's tolerance. TIGTA referred this preparer to the IRS' Criminal Investigation function. The IRS requested information from TIGTA regarding other questionable preparers who may be avoiding IRS scrutiny. TIGTA provided the requested information to the Service on other preparers. Among them:

—One preparer has filed 1,019 claims totaling over $677,000. The claims are all under IRS' tolerance, and most of the claims are for one of five amounts that are repeated on the filed claims.

—Another preparer has filed 1,138 claims. The preparer has filed returns for taxpayers in 31 different States. In addition to telephone excise tax refund claims, over 95 percent of the returns also claim employee business expenses.

ENHANCE ENFORCEMENT OF THE TAX LAWS

The fiscal year 2008 budget request is designed to continue the IRS' emphasis on tax enforcement. The request increases funding for enforcement by approximately $440 million, which includes $291 million for new enforcement initiatives and $149 million in cost increases. The increase includes funding for additional enforcement personnel. According to the request, increased resources for the IRS' examination and collection programs will yield direct measurable results each year of $699 million.

Included in the IRS' fiscal year 2008 budget request is an initiative to improve compliance estimates and measures, and also improve detection of non-compliance.

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[11] Ongoing Audit—*Telephone Excise Tax Refund* (TIGTA Audit Number 200630036).

[12] Various schedules may be attached to a tax return, if needed. Schedule C is for reporting Profit or Loss From Business; Schedule E is for Supplemental Income and Loss; and Schedule F is for Profit or Loss From Farming.

[13] The Earned Income Tax Credit (EITC) is a refundable credit designed to help move low-income taxpayers above the poverty level.

This enforcement initiative would fund research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance. Unlike the past, the IRS plans to conduct an annual study of compliance among Form 1040 filers based on a smaller sample size than the 2001 National Research Program study.

TIGTA reviewed the tax gap estimates that were developed from the 2001 National Research Program data and concluded that the IRS still does not have sufficient information to completely and accurately assess the overall tax gap and voluntary compliance rate. Although having new information about Tax Year (TY) 2001 individual taxpayers is an improvement when compared to the much older TY 1988 information from the last major compliance study, some important individual compliance information remains unknown. Additionally, although individuals comprise the largest segment of taxpayers and were justifiably studied first, no new information is available about employment, small corporate, large corporate and other compliance segments. With no firm plans for further studies or updates in many areas of the tax gap, the current tax gap estimate is an unfinished picture of the overall tax gap and compliance rate.

The IRS' fiscal year 2008 budget request also includes funding for an initiative to improve compliance among small business and self-employed taxpayers in the areas of reporting, filing, and payment by increasing audits of high-risk tax returns, collecting unpaid taxes, and investigating and, where appropriate, prosecuting persons who have evaded taxes. According to the budget request, this initiative would produce $144 million in additional annual enforcement revenue, once newly hired employees reach their full performance potential in fiscal year 2010.

MODERNIZE THE IRS THROUGH ITS PEOPLE, PROCESSES AND TECHNOLOGY

The IRS must optimally manage its resources, business processes, and technology systems to effectively and efficiently support its service and enforcement mission. The IRS' fiscal year 2008 budget request includes initiatives to update critical information technology infrastructure ($60 million), and to enhance the IRS' Computer Security Incident Response Center (CSIRC) and its network infrastructure security ($21 million).

Upgrading the Service's critical IT infrastructure initiative would include upgrading equipment that has exceeded its life cycle. According to the budget request, failure to replace the IRS' IT infrastructure will lead to increased maintenance costs and increase the risk of disrupting business operations. Planned expenditures in fiscal year 2008 include replacing desktop computers, automated call distributor hardware, mission critical servers, and Wide Area Network/Local Area Network routers and switches.

Enhancing the CSIRC would require $13.1 million to allow the CSIRC to keep pace with the ever-changing security threat environment through improved detection and analysis capability, improved forensics, and increased capacity to identify and respond to potential intrusions before they occur. An additional $7.9 million would fund enhancements to the IRS' network infrastructure security, providing the capability to perform continuous monitoring of the security of operational systems, using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Less than two months ago, TIGTA reported that IRS employees reported the loss or theft of at least 490 computers and other sensitive data in 387 separate incidents. Employees reported 296 (76 percent) of the incidents to the TIGTA Office of Investigations but not to the CSIRC. In addition, employees reported 91 of the incidents to the CSIRC; however, 49 of these were not reported to TIGTA's Office of Investigations. IRS procedures require employees to report lost or stolen computers to both the IRS CSIRC and to TIGTA's Office of Investigations. TIGTA reported that coordination was inadequate between the CSIRC and TIGTA's Office of Investigations to identify the full scope of the losses.[14]

Prior to the Department of Veterans Affairs data loss incident in May 2006, the CSIRC had not placed sufficient emphasis on identifying actual taxpayers potentially affected by lost or stolen computers. TIGTA's Office of Investigations did investigate many of these incidents but focused on criminal aspects (e.g., identifying the perpetrator and recovering the stolen equipment).

On July 7, 2006, the Chief, Mission Assurance and Security Services, issued a memorandum that re-emphasized reporting requirements and stated that all com-

[14] *The Internal Revenue Service Is Not Adequately Protecting Taxpayer Data on Laptop Computers and Other Portable Electronic Media Devices* (TIGTA Reference Number 2007–20–048, March 23, 2007).

puter security incidents shall be reported to the CSIRC and to front-line managers. In addition, any incident involving physical loss of equipment that could result in unauthorized access to IRS systems or information must also be reported to the TIGTA Office of Investigations. The IRS Commissioner had issued an earlier email reminding all managers to safeguard personally identifiable information and to immediately report any security incidents to the CSIRC. The email message also stated that managers work with the CSIRC to promptly notify the TIGTA Office of Investigations when appropriate. As a final measure to ensure total coordination, the IRS has entered into an agreement with the TIGTA Office of Investigations to share reports of all incidents relating to the loss or theft of IT assets.

The Service's fiscal year 2008 budget request includes an initiative to fund Business Systems Modernization. The initiative would provide approximately $62.1 million to continue the development and deployment of the IRS' modernization program in line with the recommendations identified in the IRS' Modernization, Vision, and Strategy. According to the request, the increase would allow the IRS to continue progress on modernized projects, such as the Customer Account Data Engine (CADE) and Modernized e-File (MeF).

CADE is the IRS' lynchpin modernization project that will replace the antiquated master file system, which is based on a 1960s architecture. The IRS is developing CADE in stages and expects to retire the Individual Master File in 2012. When fully operational, the CADE database will house tax information for more than 200 million individual and business taxpayers. Congress authorized $58 million for the CADE in fiscal year 2007. Through fiscal year 2007, CADE project release costs total about $233.9 million. The IRS initiated the CADE project in September 1999 and began delivering releases in August 2004.

During Calendar Year (CY) 2006, the CADE posted over 7.3 million tax returns and generated more than $3.4 billion in refunds. This is a significant increase over the 1.4 million tax returns posted in CY 2005 that generated refunds totaling more than $427 million. The CADE is now in the process of completing delivery of Release 2.2. Release 2.2 will process 2007 Filing Season tax law revisions (Tax Year 2006) and additional tax forms.[15]

On February 27, 2007, the IRS put Release 2.2 into production, but because computer reports on the number of returns received did not match the number of returns posted, the CADE was turned off and tax returns were sent back to the current IRS processing system. The IRS reports that a major portion of Release 2.2 was successfully put into production on March 6, 2007 (seven weeks late). On the first day, it posted over 571,000 tax returns of which 566,332 contained refunds. Because of the late start into production, the IRS goal of using the CADE to process 33 million tax returns will not be met. According to IRS officials, the latest estimate was that the IRS would complete the deployment of Release 2.2 by the end of April 2007, and it would post between 16 million and 19 million returns during the 2007 Filing Season. As of April 27, 2007, the CADE has processed 10.3 million returns with $10.9 billion in refunds.

From the project's beginning, there has been a pattern of deferring CADE requirements to later releases and missing release deployment dates. Allowing this pattern to continue will undermine the long-term success of the project. To meet the CADE's long-term computer processing demands, further consideration needs to be given to alternative design approaches. The project design currently includes building a computer system large enough to process the highest daily volume of tax returns received by the IRS even though this processing capacity is needed for only a few days each year. Alternative design solutions, such as obtaining additional computer resources on an interim basis or delaying the processing of some tax return types on extremely high-volume processing days, have been considered but have not been thoroughly developed. In addition, based on the current design of the project, meeting storage and processing demands may be cost prohibitive.

MeF is the future of electronic filing. It provides a single Extensible Markup Language-based standard for filing electronic tax returns. Standardizing the formats/structures for all filings will allow transmitters to submit multiple return types in the same transmission, something that currently restrains e-file growth. In fiscal year 2008, the IRS has scheduled to start development and implementation of the Form 1040 on the MeF platform, which is expected to take two years. TIGTA is currently concluding an audit of the MeF and will report the results later this spring.

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[15] DRAFT Audit Report—*Vital Decisions Must Be Made to Ensure Successful Implementation of Customer Account Data Engine Capabilities* (TIGTA Audit Number 200620012, dated May 1, 2007).

LEGISLATIVE PROPOSALS

The fiscal year 2008 budget request includes several legislative proposals that would provide the IRS with additional enforcement tools to improve compliance. It is estimated that these proposals could generate approximately $29 billion in revenue over the next 10 years. These proposals would expand information reporting, improve compliance by businesses, and expand penalties. This enforcement initiative includes funding for purchasing software and making modifications to the IRS' IT systems, which are necessary to implement these legislative proposals.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION FISCAL YEAR 2008 BUDGET REQUEST

TIGTA was created by Congress to provide independent oversight of the IRS. TIGTA's investigations and audits protect and promote the fair administration of the Nation's tax system. TIGTA's responsibilities include ensuring that the IRS is accountable for more than $2 trillion in tax revenue received each year. TIGTA's investigations protect the integrity of IRS employees, contractors, and other tax professionals; provide for infrastructure security; and protect the Service from external attempts to threaten or corrupt the administration of tax laws. TIGTA conducts audits that advise Congress, the Secretary of the Treasury, and IRS management of high-risk issues, problems, and deficiencies related to the administration of IRS programs and operations. TIGTA's audit recommendations aim to improve IRS systems and operations, while maintaining fair and equitable treatment of taxpayers.

TIGTA's Office of Audit (OA) provides comprehensive coverage and oversight of all aspects of the Service's daily operations. Audits not only focus on the economy and efficiency of IRS functions but also ensure that taxpayers' rights are protected and the taxpaying public is adequately served. Overall, as of March 31, 2007, audit reports potentially produced financial accomplishments of $579 million, and potentially impacted approximately 379,000 taxpayer accounts in areas such as taxpayer burden, rights, and entitlements. OA develops an annual audit plan that communicates oversight priorities to Congress, the Department of the Treasury, and the IRS. Emphasis is placed on mandatory coverage imposed by the IRS Restructuring and Reform Act of 1998 [16] and other statutory authorities, as well as issues impacting computer security, taxpayer rights and privacy, and financial-related audits. OA's work focuses on IRS' major management challenges, IRS' progress in achieving its strategic goals, eliminating IRS' systemic weaknesses, and the Service's response to the President's Management Agenda initiatives.

TIGTA's mission includes the statutory responsibility to protect the integrity of tax administration and to protect the ability of the IRS to collect revenue for the Federal Government. To accomplish this, TIGTA's Office of Investigations (OI) investigates allegations of criminal violations and administrative misconduct by IRS employees, protects the Service against external attempts to corrupt tax administration, and ensures IRS employee safety and IRS data and infrastructure security. Employee investigations include extortion, theft, taxpayer abuses, false statements, financial fraud, and unauthorized access (UNAX) of confidential taxpayer records by IRS employees. Investigations of external attempts to corrupt tax administration include bribes offered by taxpayers to compromise IRS employees, the use of fraudulent IRS documentation to commit crimes, taxpayer abuse by tax practitioners, impersonation of Service employees, and the corruption of IRS programs through procurement fraud. TIGTA assists in maintaining IRS employee and infrastructure security by investigating incidents of sabotage, and threats or assaults made against IRS employees, facilities, and infrastructure.

From fiscal year 2001 to fiscal year 2006, TIGTA's labor expenses have grown 22 percent from $88 million to $107.3 million, despite a substantial reduction in FTEs (a decrease of 11 percent from 938 to 838). Labor costs currently account for 81 percent of TIGTA's annual budget. Labor and rent together consume approximately 87 percent of the annual budget. The fiscal year 2007 President's budget request for TIGTA was $136.5 million. TIGTA's actual fiscal year 2007 funding level was $132.9 million, a $3.6 million reduction (2.6 percent decrease). Total resources required in fiscal year 2008 to support its mission are $140.6 million.[17]

Since fiscal year 2001, TIGTA has achieved its performance and quality expectations by implementing several efficiency and cost-cutting initiatives. From fiscal

[16] Pub. L. No. 105–206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

[17] *U.S. Department of the Treasury Fiscal Year 2008 Budget in Brief*, February 5, 2007, pages 29–31.

year 2001 to fiscal year 2006, discretionary spending (such as training, travel, equipment, etc.) fell nearly 21 percent from $19.5 million to $15.4 million. These costs currently consume only 12 percent of TIGTA's annual budget. Through incremental FTE losses and implementation of cost-cutting initiatives in non-labor expense categories, TIGTA has been able to finance annual pay and labor-related benefit increases (health care, pensions and retirement) while also maintaining the FTE level necessary to meet performance and quality expectations.

TIGTA's efficiency-enhancing and cost-cutting initiatives are largely exhausted. The impact of a budget reduction in fiscal year 2008 will fall almost exclusively on labor and, would affect TIGTA's capability to provide comprehensive oversight of IRS operations. TIGTA has lost 100 FTEs because budget increases have not been adequate to finance annual pay increases, labor-related benefit increases, and non-labor related requirement expenses such as contracts, rent, and equipment. Because of decreasing budgets, TIGTA's overall employee population has declined 12 percent from fiscal year 2001 to fiscal year 2006 (a decrease from 938 in fiscal year 2001 to 825 at end of fiscal year 2006) and is expected to continue to decline over the foreseeable future. In addition, 39 percent of TIGTA's current staff is retirement eligible through fiscal year 2010, threatening TIGTA's overall ability to effectively fulfill its core missions.

Labor reductions would reduce TIGTA's enforcement capacity and circumscribe efforts to combat IRS employee misconduct and external threats to the security and integrity of IRS personnel and infrastructure. FTE losses would result in fewer opportunities to examine high-risk areas and, thus, reduce financial benefits from audit recommendations and impact fewer taxpayer accounts. Losses would also require TIGTA to curtail, delay and/or fail to initiate reviews of high-risk areas and/or eliminate entire programs.

TIGTA must also address human capital issues. In order to accomplish its mission, TIGTA employees need to possess the necessary skills. Because of the increasingly modernized and computerized IRS operating systems and environment, the most critical gaps TIGTA faces are in the Auditor and Criminal Investigator occupations.

TIGTA also faces the challenge of addressing increasing requests from Congress and other IRS stakeholders in a timely and efficient manner. In fiscal year 2007, TIGTA has reallocated resources in order to perform congressionally requested audits and comply with new statutory provisions. TIGTA anticipates increased congressional interest and requests in future years.

The fiscal year 2008 President's budget request for TIGTA will be used to continue to provide critical audit and investigative services, ensuring the integrity of tax administration on behalf of the Nation's taxpayers. While there are a number of critical areas in which TIGTA will provide oversight, highlights of TIGTA's investigative and audit priorities include:

—Adapting to the IRS' continuously evolving operations and mitigating intensified risks associated with modernization, outsourcing, and enforcement efforts;
—Responding to threats and attacks against IRS personnel, property, and sensitive information;
—Improving the integrity of IRS operations by detecting and deterring fraud, waste, abuse, or misconduct by IRS employees;
—Conducting comprehensive audits that include recommendations for cutting costs and enhancing IRS service to taxpayers; and
—Informing Congress and the Secretary of the Treasury of problems and the progress being made to resolve them.

Total resources needed in fiscal year 2008 to support TIGTA's mission are $141,753,000, including $140,553,000 from direct appropriations and approximately $1,200,000 from reimbursable agreements. Budget adjustments to maintain current levels in fiscal year 2008 include $4.87 million to fund the cost of the January 2007 pay increase, the proposed January 2008 pay raise, and non-labor related items.

I hope my discussion of some of the fiscal year 2008 budget and 2007 Filing Season issues will assist you with your oversight of the IRS. Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to share my views.

Senator DURBIN. Ms. Olson.

STATEMENT OF NINA E. OLSON

Ms. OLSON. Mr. Chairman and distinguished members of the subcommittee: Thank you for inviting me to testify on the proposed budget of the Internal Revenue Service for fiscal year 2008.

In developing the IRS budget, the logical starting point is to consider the IRS's fundamental mission. The IRS is the Nation's tax collector and its overriding objective should be to maximize voluntary compliance with the tax laws. In my view the IRS should go about maximizing voluntary compliance in four ways:

First, by improving its outreach and education efforts to minimize inadvertent errors attributable to tax law or procedural complexity or confusion;

Second, by conducting compliance-oriented audits to reinforce the perception that taxpayers may be audited;

Third, by utilizing all IRS collection alternatives while collecting tax debts, to bring taxpayers into future compliance;

And fourth, by reserving targeted enforcement actions to combat clear abuses.

In addition, the IRS should launch a public information campaign that reminds taxpayers of what taxes really are about, the price we pay for a civilized society.

I strongly encourage the subcommittee to fund the IRS at approximately the level requested by the administration for fiscal year 2008. In my annual report to Congress, I recommended that Congress provide the IRS with after-inflation increases of about 2 to 3 percent a year for the foreseeable future.

Assuming the funds are wisely spent, I believe that increasing the IRS budget at this rate is an excellent financial investment. The IRS collects about 96 percent of all Federal revenue. The more revenue the IRS collects, the more revenue Congress may spend on other programs or use to cut taxes or reduce the deficit. The less revenue the IRS collects, the less revenue Congress has available for these other purposes.

If the Federal Government were a private company, its management clearly would fund the accounts receivable department at whatever level it believed would maximize the company's bottom line. Since the IRS is not a private company, maximizing the bottom line is not in and of itself an appropriate goal. But the public sector analogy should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden.

Studies show that if the IRS were given more resources, it could collect substantially more revenue. One of the most critical choices facing tax administration is how to allocate resources between taxpayer service and tax law enforcement. While I believe that both categories would benefit from additional funding, I am concerned that the IRS has been emphasizing enforcement at the expense of taxpayer service. Since fiscal year 2004, funding for enforcement has increased substantially, while funding for taxpayer service has been reduced. For fiscal year 2008, the administration has requested a funding increase of 6.5 percent for enforcement to $7.2 billion and 3.8 percent for taxpayer service to $3.6 billion. If the administration's proposal is enacted, funding for enforcement will have increased by 19.4 percent and funding for taxpayer service will have been reduced by 3.8 percent over the 5-year period from fiscal year 2004 to 2008.

I am deeply concerned about this fundamental shift in the balance between taxpayer service and enforcement. Under the pro-

posal the IRS would be spending literally twice as much on enforcement as it spends on taxpayer service. There is no reliable data showing that more enforcement will do more than taxpayer service to increase compliance.

I believe the IRS can produce a positive return on investment from more funding in both areas, but, given limited resources, I think it is misguided to ramp up enforcement at the expense of taxpayer service. Moreover, the absence of an accurate measure of return on investment leads to misguided efforts to privatize inherently governmental activities, such as tax collection, harming taxpayers and tax administration in the process.

Because taxpayer service and enforcement are drivers of overall compliance, we need to measure taxpayer service needs concurrently with our efforts to measure the tax gap. Thus, I believe in addition to additional research about what causes taxpayers to be noncompliant, the national research program should update its analysis of taxpayer service needs at the same time it is measuring taxpayer noncompliance for the particular taxpayer population it is studying. The IRS can then make an informed resource allocation only by being armed with information of both types.

Thank you.

Senator DURBIN. Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF NINA E. OLSON

Mr. Chairman, Ranking Member Brownback, and distinguished Members of the Subcommittee: Thank you for inviting me to submit this written statement regarding the proposed budget of the Internal Revenue Service for fiscal year 2008.[1] I will address the mission of the IRS, the overall level of funding I believe the agency should receive, the allocation of that funding between enforcement and taxpayer service, and then a number of important issues in tax administration in which I believe this Committee may have an interest. I approach these issues from my perspective as the National Taxpayer Advocate, the voice for taxpayers and taxpayer rights inside the IRS.

THE OVERRIDING MISSION OF THE IRS SHOULD BE TO INCREASE VOLUNTARY COMPLIANCE

In developing the IRS budget, the logical starting point is to consider the IRS's fundamental mission. The IRS is the nation's tax collector, and its overriding objective should be to maximize voluntary compliance with the tax laws. In general, the IRS seeks to achieve compliance through two main types of activity. First, it seeks to enable taxpayers to comply with their tax obligations voluntarily. In most cases, outreach, education, and taxpayer assistance are sufficient to produce complete or substantial compliance. Second, it targets its enforcement resources at taxpayers who are unwilling to comply with the tax laws.

Voluntary compliance—as opposed to enforced compliance—must be our goal for two overriding reasons.

—First, it is far preferable for our civic culture when taxpayers pay voluntarily rather than pursuant to enforcement action. We should strive to make sure taxpayers understand how the tax dollars they pay are used to protect and benefit them, and we should make compliance as easy as possible.

[1] The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. The statute establishing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Accordingly, congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

—Second, enforced compliance is extremely expensive and therefore must be targeted narrowly. For fiscal year 2006, the IRS reported that its face-to-face audit rate was 0.23 percent, meaning that only one out of every 435 taxpayers was audited in person.[2] Even taking into account less comprehensive correspondence audits, the audit rate was less than one percent.[3] Notably, IRS enforcement actions brought in only about two percent ($48.7 billion)[4] of total IRS collections ($2.24 trillion).[5] As the IRS has acknowledged, it is simply not realistic to close the tax gap one taxpayer at a time.

In my view, the IRS should go about maximizing voluntary compliance in four ways:

—By improving its outreach and education efforts to minimize inadvertent errors attributable to tax law or procedural complexity or confusion;

—By conducting compliance-oriented audits to reinforce the perception that taxpayers may be audited;

—By utilizing all IRS collection alternatives while collecting tax debts to bring taxpayers into future compliance; and

—By reserving targeted enforcement actions to combat clear abuses.

In addition, the IRS should launch a public information campaign that reminds taxpayers of what taxes really are about—the price we pay for a civilized society.

CONGRESS SHOULD PROVIDE INCREASES IN IRS PERSONNEL FUNDING AT A STEADY BUT GRADUAL PACE, PERHAPS TWO PERCENT TO THREE PERCENT A YEAR ABOVE INFLATION

I strongly encourage the Committee to fund the IRS at approximately the level requested by the Administration for fiscal year 2008. In the National Taxpayer Advocate's 2006 Annual Report to Congress, we recommended that Congress provide the IRS with after-inflation increases of about two percent to three percent a year for the foreseeable future. Assuming the funds are wisely spent, I believe that increasing the IRS budget at this rate is an excellent financial investment.

The IRS collects about 96 percent of all federal revenue.[6] The more revenue the IRS collects, the more revenue Congress may spend on other programs or use to cut taxes or reduce the deficit. The less revenue the IRS collects, the less revenue Congress has available for these other purposes.

If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at whatever level it believed would maximize the company's bottom line. Since the IRS is not a private company, maximizing the bottom line is not—in and of itself—an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. Studies show that if the IRS were given more resources, it could collect substantially more revenue.

In his final report to the IRS Oversight Board in 2002, former Commissioner Charles Rossotti presented a discussion titled "Winning the Battle but Losing the War" that detailed the consequences of the lack of adequate funding for the IRS. He identified 11 specific areas in which the IRS lacked resources to do its job, including taxpayer service, collection of known tax debts, identification and collection of tax from non-filers, identification and collection of tax from underreported income, and noncompliance in the tax-exempt sector.

Commissioner Rossotti provided estimates of the revenue cost in each of the 11 areas based on IRS research data. In the aggregate, the data indicated that the IRS lacked the resources to handle cases worth about $29.9 billion each year. It placed

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[2] Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006). The actual face-to-face audit rate is apparently lower than the IRS reported. According to a study by the Treasury Inspector General for Tax Administration, the IRS classifies its audits based on which IRS function handled a case. Some cases referred to the IRS function responsible for conducting face-to-face audits are resolved without a face-to-face meeting. By analyzing data from IRS Audit Technique Codes, TIGTA concluded that the face-to-face audit rate was 0.18 percent for fiscal year 2006, about 22 percent less than the IRS reported. See Treasury Inspector General for Tax Administration, Ref. No. 2007–30–056, *Trends in Compliance Activities Through Fiscal Year 2006* at 2 (March 27, 2007); Allen Kenney, *TIGTA Finds Audit-by-Mail Process More Common Than IRS Says*, Tax Notes Today (April 6, 2007).

[3] Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006).

[4] Id.

[5] Government Accountability Office, GAO–07–136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* at 95 (Nov. 2006). The IRS actually collected $2.51 trillion on a gross basis in fiscal year 2006, but issued $277 billion in tax refunds.

[6] Government Accountability Office, GAO–07–136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 68 (Nov. 2006).

the additional funding the agency would have needed to handle those cases at about $2.2 billion.[7]

Significantly, this estimate reflects only the potential direct revenue gains. Economists have estimated that the indirect effects of an examination on voluntary compliance provide further revenue gains. While the indirect revenue effects cannot be precisely quantified, two of the more prominent studies in the area suggest the indirect revenue gains are between six and 12 times the amount of a proposed adjustment.[8]

I want to emphasize that the existing modeling in this area is not especially accurate, and estimates of both the direct and indirect effects of IRS programs vary considerably. As I will discuss below, the IRS needs to develop better modeling to produce more accurate return-on-investment estimates. But I also want to emphasize that almost all studies show that, within reasonable limits, each additional dollar appropriated to the IRS should generate substantially more than an additional dollar in federal revenue assuming the funding is wisely spent.

IRS FUNDING INCREASES SHOULD BE BALANCED BETWEEN TAXPAYER SERVICE AND ENFORCEMENT

One of the most critical choices facing tax administration is how to allocate resources between taxpayer service and tax-law enforcement. While I believe that both categories would benefit from additional funding, I am concerned that the IRS has been emphasizing enforcement at the expense of taxpayer service.

Since fiscal year 2004, funding for enforcement has increased substantially while funding for taxpayer service has been reduced. For fiscal year 2008, the Administration has requested a funding increase of 6.5 percent for enforcement (to $7.2 billion) and 3.8 percent for taxpayer service (to $3.6 billion).[9] If the Administration's proposal is enacted, funding for enforcement will have been increased by 19.4 percent and funding for taxpayer service will have been reduced by 3.8 percent over the five-year period, fiscal year 2004-fiscal year 2008.[10]

I am deeply concerned about this fundamental shift in the balance between taxpayer service and enforcement. Under this proposal, the IRS would be spending literally twice as much on enforcement as it spends on taxpayer service. There is no reliable data showing that more enforcement will do more than taxpayer service to increase compliance. I believe the IRS can produce a positive return on investment from more funding in both areas. But given limited resources, I think it is misguided to ramp up enforcement at the expense of taxpayer service.

I discuss some of the specific consequences of this shortchanging of taxpayer service in the Appendix to this testimony. However, I want to emphasize that the concerns I am expressing about the relative shift in emphasis from taxpayer service to enforcement do not reflect simply the misgivings of a zealous taxpayer advocate. My concerns are shared by former IRS Commissioner Rossotti. In a memoir about his experience running the IRS from 1997 to 2002, Mr. Rossotti wrote:

"Some critics argue that the IRS should solve its budget problem by reallocating resources from customer support to enforcement. In the IRS, customer support means answering letters, phone calls, and visits from taxpayers who are trying to pay the taxes they owe. Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money."[11]

Why is the IRS today putting greater emphasis on enforcement? My sense is that there are two factors at play.

In the aftermath of the IRS Restructuring and Reform Act of 1998, the IRS focused on improving taxpayer service, and its enforcement presence declined. Some observers believe that the IRS's response to the 1998 Act went too far and that the current emphasis on enforcement is needed to restore the balance that existed pre-

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[7] Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002).

[8] Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35–36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax*, 1977–1986, 43 Nat. Tax J. 395, 396, 405 (1990).

[9] Government Accountability Office, GAO–07–673, *Internal Revenue Service: Interim Results of the 2007 Tax Filing Season and the Fiscal Year 2008 Budget Request* 26 (April 2007).

[10] Id. at 27. These numbers are apparently not adjusted for inflation. GAO reports that overall IRS funding would increase, on an inflation-adjusted basis, by a mere 0.5 percent from fiscal year 2004 to fiscal year 2008 under the Administration's proposal. Id. at 26.

[11] Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 285 (2005).

viously. Significantly, this reasoning rests on the premise that the relative balance between service and enforcement that existed prior to 1998—when IRS answered taxpayers' phone calls only 51 percent of the time [12]—was the "correct" one.

That may or may not be the case. The IRS's current strategic formula, "Service + Enforcement = Compliance," [13] does not contain any coefficients. Did the improvements in service more than balance out the reductions in enforcement, or did compliance suffer? There is no hard data either way, so we're all left to make educated guesses.

In the absence of hard data, I do not believe it is sound public policy to make a shift from helping taxpayers comply on the front end toward clamping down on taxpayers on the back end. The government should prefer to treat its taxpayers courteously and with respect. While enforcement actions are clearly necessary, I think it is unwise to make a significant shift in the relative emphasis on taxpayer service and enforcement in the absence of data showing it would produce a significant boost in overall tax compliance.

The second factor supporting more enforcement funding are the congressional scoring rules. "Direct" enforcement revenue is "scorable," while current modeling does not permit economists to measure the return-on-investment of funds spent on taxpayer service or on the "indirect" (i.e., deterrent) effect of enforcement spending. While this is understandable, it may be leading to bad results. As I noted above, direct enforcement revenue ($48.7 billion in fiscal year 2006) comes to only about two percent of overall IRS collections. To make budgeting decisions by striving to maximize two percent of collections without grappling adequately with what is required to maximize the remaining 98 percent of collections is a bit like letting the tail wag the dog.

The Administration's fiscal year 2008 budget request acknowledges this problem. It states: "The IRS cannot currently measure either the impact of deterrence or service, but they are positive." [14] Then, having acknowledged that the effects of spending that brings in 98 percent of Federal revenue cannot be measured, the budget goes on to recommend the use of a "program integrity cap." Under this concept, additional funding can be provided that does not count against the budget caps if certain conditions are satisfied, notably that the Congressional Budget Office can certify the spending will produce a positive return on investment and thus will not increase the budget deficit. Since the return on taxpayer service spending cannot be quantified, the "program integrity cap" approach leads inexorably toward greater funding for enforcement.

For the reasons I have described, I urge the Committee to consider carefully the appropriate balance between taxpayer service and enforcement in making funding decisions for the fiscal year 2008 IRS budget. Many aspects of taxpayer service are akin to a wholesale operation that reaches groups of taxpayers (e.g., outreach and education), while IRS audits constitute a far more costly retail operation that requires individual taxpayer contact. The IRS should pursue a balanced approach to tax compliance that puts priority emphasis on improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear abuses and send a message to all taxpayers that noncompliance has consequences.[15]

THE IRS SHOULD DEVOTE MORE RESOURCES TO OBTAINING BETTER RESEARCH TO IMPROVE ITS STRATEGIC PLANNING AND RESOURCE ALLOCATION DECISIONS

As described above, the IRS currently does not know whether its next dollar is better spent on taxpayer service or enforcement. It does not know within either category where its funds can be most efficiently deployed. The IRS will be much better off if it has better information to guide its resource allocation decisions.

Congress should consider directing the IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its return on investment (ROI) estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions, including the downstream costs of such work. Improved methods should also be developed to verify, retrospectively, the marginal ROI that the IRS has achieved for each category of work.

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[12] Annual IRS Restructuring and Reform Act of 1998 Joint Congressional Review, Testimony of Mark W. Everson, Commissioner, Internal Revenue Service (May 20, 2003) (indicating level of service on the telephones for fiscal year 1998).

[13] IRS Strategic Plan 2005–2009.

[14] Department of the Treasury, Fiscal Year 2008 Budget-in-Brief at 56.

[15] For research purposes, we believe it is important to study inadvertent errors as well as deliberate misreporting. Knowledge about inadvertent errors can be used to clarify ambiguous laws or administrative guidance both to help increase future compliance and to better apply IRS outreach, education, and other voluntary compliance initiatives.

Among other things, the IRS should measure and report to Congress on its progress in handling all significant categories of work, including the known workload, the percentage of the known workload the IRS is able to handle and the percentage of the known workload the IRS is not able to handle, the additional resources the IRS would require to perform the additional work, and the likely return-on-investment of performing that work.[16]

The IRS Can and Should Do a Better Job of Measuring the Impact of Taxpayer Service on Compliance

The Taxpayer Assistance Blueprint (TAB) notes that it is difficult to measure the impact of taxpayer service on compliance. Of the private sector and government entities that the TAB team surveyed, all had concluded that customer service at least indirectly impacts their organizations, but only one had attempted to empirically measure that impact.

Although little work has been done in this area, I believe the IRS does have the capability to develop useful estimates, and I am suggesting a general framework for conducting this research. Measuring the compliance impact of customer service would entail identifying a group of taxpayers who received a particular service (the "treatment group") and an otherwise comparable group that did not receive that service (the control group). Compliance of both groups could then be measured on returns filed subsequent to the receipt of service by the treatment group. The three measures used to estimate the tax gap could be applied—payment compliance, filing compliance, and reporting compliance.

We can determine the payment compliance of survey respondents by simply observing whether the full tax liability was paid at the time of filing. We can estimate their filing compliance by determining whether non-filers appeared to have a filing requirement. To determine reporting compliance, by far the biggest component of the tax gap, we could use IRS-developed algorithms for estimating reporting compliance. These algorithms have been updated based on results from the recently completed National Research Program (NRP) and should provide good preliminary estimates. The estimates could subsequently be validated during the next NRP by comparing actual reporting compliance against predicted reporting compliance based on the IRS algorithms.

Measuring the Direct Effect

If we accept the above proposed framework as a valid means of estimating compliance, surveys could then be designed and administered to identify groups of taxpayers who did or did not receive certain services, such as telephone or Internet assistance with tax law questions, Internet or walk-in site (also known as Taxpayer Assistance Center or TAC) assistance obtaining forms, etc. Subsequent compliance of those who receive the service could then be compared to compliance for a comparable group who do not. Taxpayer satisfaction with services received might also be an interesting variable to examine.

Measuring Indirect Effects

It is possible that taxpayer compliance behavior may be influenced by knowledge and attitudes about IRS customer service offerings, even if the affected taxpayers have not used those services. The same basic proposed framework could be used to measure these indirect effects. We would have to determine a set of relevant attributes to identify taxpayer groups indirectly affected by IRS customer service offerings. It seems to me that such attributes would probably include use, awareness, access and general satisfaction level:

—*Use*.—To be indirectly affected, a taxpayer could not have used the service in question (at least during the year being studied).

—*Awareness*.—A taxpayer would have to be aware of the existence of a service to be influenced by it.

—*Access*.—It seems likely that taxpayers who could access the service if they chose to are more likely to be influenced (e.g., those living close to a TAC).

—*Satisfaction Level*.—It seems likely that taxpayers having a generally favorable level of satisfaction with our services are more likely to be positively influenced (and vice versa).

Surveys could be administered to determine whether compliance was impacted based on the values for the above attributes (or others suspected of indirectly affecting compliance).

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[16] Much of this information was published in former Commissioner Rossotti's final report to the IRS Oversight Board. Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002). However, we have not seen updated statistics published in this format since that time.

Return Preparation

The IRS has data that enable us to estimate compliance for the entire population of returns by type of preparation: IRS prepared, volunteer, commercial, and taxpayer prepared. It would be instructive to compare estimated reporting compliance for IRS prepared returns against comparable returns (i.e., low income, especially Earned Income Tax Credit) prepared by the other methods. If the data show that IRS-prepared returns are substantially more compliant, the IRS might decide to expand return preparation in the TACs.[17]

The IRS Should Include the Cost of the Downstream Consequences of Its Actions in Its Return on Investment (ROI) Calculations

The IRS needs to conduct more thorough and accurate analyses when measuring return on investment (ROI) in order to allocate future dollars appropriately. For example, although in the short run it may cost more to process and review an Offer in Compromise and it may appear that the government is writing off revenue, the taxpayer in the long run may pay more tax dollars into the system as a result of his promise to be fully compliant for the five succeeding years.[18] Five years is a long enough period to enable the taxpayer to "learn" a new norm of behavior—namely, compliance. And when you compare the 16 cents on the dollar that IRS receives from offers [19] to the virtually no cents it collects after year 3 of the 10-year collection period,[20] the Offer in Compromise suddenly looks like a very efficient and productive program.

When computing ROI, the IRS should include the costs of the downstream consequences of its enforcement actions, which include the costs associated with cases handled by Appeals or the Taxpayer Advocate Service. Downstream consequences analysis tells us not only true ROI (i.e., the true cost to the IRS) but also gives us clues as to how to improve our processes from an IRS and a taxpayer perspective. That is, downstream consequences analysis is a form of taxpayer service.

The IRS Should Conduct Research, Organized by Taxpayer Segment, to Better Understand Taxpayer Behavior and Taxpayer Response to IRS's Various Service and Enforcement "Touches"

The absence of research about taxpayer needs often leads the IRS to place its immediate resource needs over taxpayers' immediate and long-term needs.[21] This approach may cause more taxpayers to become noncompliant, thereby requiring more expensive enforcement actions. Concern over the lack of research and taxpayer-centric strategic planning led Congress to enact Section 205 of the fiscal year 2006 Appropriations Act funding the IRS and to direct the IRS to develop a five-year strategic plan for taxpayer service.[22]

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[17] As I discuss in the Appendix, existing data suggest that EITC returns prepared in the TACs are more compliant than other returns.

[18] If a taxpayer fails to comply with all his tax obligations over the five-year period following IRS acceptance of an offer, the IRS may rescind the offer and reinstate the tax debt. See IRS Form 656, Offer in Compromise.

[19] IRS Small Business/Self Employed Division, Offer In Compromise Program, *Executive Summary Report* (Jan. 2006).

[20] IRS Automated Collection System Operating Model Team, Collectibility Curve (August 5, 2002).

[21] The declining number of Taxpayer Assistance Center (TAC) visits is an example of IRS placing its resource needs over taxpayer needs. For fiscal year 2006, IRS established a goal of preparing 20 percent fewer tax returns in TACs than in fiscal year 2005. Not surprisingly, TAC visits for year-to-date fiscal year 2006 have declined 14 percent compared with this time last year. Even though the decline in TAC usage appears to result from IRS-imposed limitations on service, the IRS is nonetheless citing this decline as a justification for making further reductions in service at the TACs. Wage & Investment, 2006 *Filing Season Data: Cumulative Statistics Report* (Feb. 25, 2006).

[22] Pub. L. No. 109–115, § 205, 119 Stat. 2396 (2005). Specifically, the statute provides:

"None of the funds appropriated or otherwise made available in this or any other Act or source to the Internal Revenue Service may be used to reduce taxpayer services as proposed in fiscal year 2006 until the Treasury Inspector General for Tax Administration completes a study detailing the impact of such proposed reductions on taxpayer compliance and taxpayer services, and the Internal Revenue Service's plans for providing adequate alternative services, and submits such study and plans to the Committees on Appropriations of the House of Representatives and the Senate for approval: . . . *Provided further,* That the Internal Revenue Service shall consult with stakeholder organizations, including but not limited to, the National Taxpayer Advocate, the Internal Revenue Service Oversight Board, the Treasury Inspector General for Tax Administration, and Internal Revenue Service employees with respect to any proposed or planned efforts by the Internal Revenue Service to terminate or reduce significantly any taxpayer service activity."

The accompanying Joint Explanatory Statement of the Committee of Conference stated: "The conferees direct the IRS, the IRS Oversight Board and the National Taxpayer Advocate to de-

I have written at length elsewhere on the need to understand the causes of noncompliance so that the IRS doesn't adopt a one-size-fits-all enforcement approach.[23] Each year, academics and other scholars propose many ideas that a 21st century tax administrator should be examining and testing. In fact, the IRS has such a vehicle for partnering with academics in the Intergovernmental Personnel Act (IPA) program. Unfortunately, this program is underutilized. The IRS must conduct and underwrite such applied research.

Because taxpayer service and enforcement are the drivers of overall compliance, we need to measure taxpayer service needs concurrently with our efforts to measure the tax gap. Thus, the National Research Program should update its analysis of taxpayer service needs at the same time it is measuring taxpayer noncompliance for the particular taxpayer population it is studying. The IRS can make informed resource allocation decisions only if it is armed with both types of information.

THE IRS SHOULD ADDRESS THE IMPACT OF IRS BUSINESS SYSTEMS MODERNIZATION LIMITATIONS ON BOTH TAXPAYER SERVICE AND ENFORCEMENT INITIATIVES

When I was in private practice as an attorney representing clients before the IRS, I did not have a full appreciation of how significant a role Business Systems Modernization (BSM) plays in both creating and solving problems for taxpayers and the IRS. As the National Taxpayer Advocate, I know that on a regular basis my office identifies systemic problems for which the complete solution requires some sort of BSM fix.

When former Commissioner Everson began his tenure, he ordered three separate reviews—two external, one internal—of the state of IRS BSM projects. Based on these reviews, the Commissioner quickly—and, I believe, correctly—concluded that the IRS was spreading its internal BSM resources too thin. Project managers and experts charged with overseeing our key initiatives—such as the Integrated Financial System (IFS) and the Customer Account Data Engine (CADE)—were also managing scores of smaller projects, all more or less important but all detracting from our central progress on IFS and CADE.

For the past several years, the IRS has focused on its primary projects and strictly controlled the number of other BSM projects. This approach makes sense because it is critical to both effective service and enforcement that the IRS move forward with its primary initiatives. On the other hand, many projects cannot be deferred too much longer without significantly impacting taxpayer rights, accuracy of taxpayer data, and effective examination and collection initiatives. Thus, Congress should ensure that the IRS has the funding to address and is addressing current taxpayer needs while the IRS moves its primary initiatives forward.

FUNDING FOR THE PRIVATE DEBT COLLECTION INITIATIVE SHOULD BE REDIRECTED TO FUND COLLECTION ACTIVITY BY IRS EMPLOYEES

In my view, the Private Debt Collection (PDC) initiative is a bad idea and should be terminated. The premise of the PDC initiative was essentially this: "There is a significant amount of tax debt that the IRS can't go after because it doesn't have the resources. If we simply turn those cases over to private collection agencies, they'll collect the debt for us and the government will get to keep 75 to 80 cent of every dollar the debt collectors are able to collect."

The problem with that simple approach is that it fails to take into account the enormous amount of IRS resources that need to be devoted to creating and supporting the program. Because tax collection is considered to be an inherently governmental function, private collection agencies (PCAs) cannot negotiate or compromise tax liabilities, interest, or penalties. Unless a taxpayer contacted by a PCA agrees to pay the tax debt in full, the case must be sent back to the IRS referral unit for additional work that only the IRS can constitutionally take on the account. Keep in mind that these are cases the IRS currently considers too unproductive to

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velop a 5-year plan for taxpayer service activities. . . . The plan should include long-term goals that are strategic and quantitative and that balance enforcement and service." H. Rep. No. 109–307, 209 (2005).

[23] See National Taxpayer Advocate 2004 Annual Report to Congress 211 (Most Serious Problem: IRS Examination Strategy) and 226 (Most Serious Problem: IRS Collection Strategy); National Taxpayer Advocate 2005 Annual Report to Congress 55 (Most Serious Problem: The Cash Economy); Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, United States Senate, on The Tax Gap (Oct. 26, 2005); Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the Committee on the Budget, United States Senate, on The Causes of and Solutions to the Federal Tax Gap (Feb. 15, 2006).

devote resources to. Yet ironically, under the PDC initiative, the IRS will end up pulling employees off high-priority, high-return cases to work on these low-priority, low-return cases.

As the IRS's PDC initiative moves forward, PCAs will be given more complex cases in order to compensate for the smaller number of easy cases. This change of course began as early as phase 1.2 of the PDC initiative, when the IRS developed case selection criteria that allowed certain nonfiler cases to be sent to the PCAs. The determination that a taxpayer is a nonfiler is a discretionary decision that can be made only by the IRS, not a private collection agency. Therefore, many of these nonfilers will raise issues only the IRS can address. The IRS intends to continue this trend of allowing PCAs to work cases that are complex and difficult to collect, such as innocent spouse cases, trust fund recovery penalty cases and business taxes.[24]

Working on these complex cases increases the likelihood that the PCAs will make mistakes and decreases the likelihood that the PCAs will be able to collect any payment from the taxpayer. Moreover, in these more complex cases, taxpayers are more likely to have questions that the PCA employees are unable to answer because their knowledge regarding tax issues is limited, at best, or because PCAs cannot exercise discretion in either answering a question or working a case. Faced with having to send the case back to the IRS referral unit, the PCAs may attempt to pressure the taxpayer into an unreasonable payment plan. As the expanded case selection increases the likelihood of IRS referral unit involvement, the underlying business case for the PCA initiative evaporates.

This approach makes little business sense, and on top of that, the program raises significant concerns about the adequacy of taxpayer rights protections and confidentiality of tax return information. In fact, to make the program profitable, the IRS will be under pressure to expand the authorized actions that private collection agencies can take on a case so they can work higher dollar, more complex cases. This expansion would clearly raise constitutional concerns.[25]

TRENDS IN TAXPAYER ADVOCATE SERVICE (TAS) CASE INVENTORY

I close with a reflection on the Taxpayer Advocate Service and its role in identifying and mitigating the downstream consequences of IRS actions and programs, and improving taxpayers' attitudes toward the tax system. This recent March 1st marked my six-year anniversary as the National Taxpayer Advocate. They have been quite remarkable years—I have watched my talented and dedicated employees achieve a quality rating of 89.7 percent for fiscal year 2006, up from 71.6 percent in 2001. The performance of TAS employees over the past two years has been particularly commendable—TAS case receipts rose an overwhelming 43 percent from fiscal year 2004 to fiscal year 2006,[26] while the number of case advocacy employees working those cases declined seven percent from 1,908 to 1,766 over the same period. Yet we have managed to handle this increased workload to date without much decline in our case quality.

The increase in TAS cases is not surprising. The IRS has substantially increased the number of its compliance actions in recent years, and about 70 percent of TAS's cases are classified as "compliance" related. Increasing the number of compliance cases inevitably produces a corresponding increase in TAS cases. Thus, the greater IRS emphasis on enforcement has resulted in a greater need for TAS services. Notably, TAS was able to obtain relief for the taxpayer in 70 percent of the cases we closed in fiscal year 2006.

TAS Customer Satisfaction surveys provide some evidence that the quality and nature of taxpayer service has an impact on taxpayer attitudes toward the tax system. When a taxpayer brings an eligible case to TAS, he is assigned a case advocate who works with him throughout the pendency of the case. Taxpayers have a toll-free number direct to that case advocate, and each TAS office has a toll-free fax number. TAS employees are required to spot and address all related issues and to educate the taxpayer about how to avoid the problem from occurring again, if possible. This level and quality of service drives TAS's high taxpayer satisfaction

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[24] Internal Revenue Service, *F&PC Advisory Council Deck* (Mar. 7 2007).

[25] For a detailed discussion of the IRS Private Debt Collection initiative and its constitutional and taxpayer rights implications, see *Use of Private Agencies to Improve IRS Debt Collection*, Subcommittee on Oversight, House Committee on Ways and Means, 108th Cong., 1st Sess. (statement of Nina E. Olson, National Taxpayer Advocate, May 13, 2003); see also National Taxpayer Advocate 2005 Annual Report to Congress 76–93.

[26] In fiscal year 2006, TAS received a total of 242,173 cases. In fiscal year 2004, TAS received a total of 168,856 cases.

scores,[27] which averaged about 4.35 on a scale of 5.0 in fiscal year 2004 and fiscal year 2005.[28] Most importantly, 57 percent of taxpayers stated that they felt better about the IRS as a whole after coming to TAS. Even among taxpayers who did not obtain the result they sought, an impressive 41 percent reported that they had a more positive opinion of the IRS because of their experience with TAS.

I am concerned that with the increasing volume, complexity, and urgency of TAS's caseload, the cycle time for our cases has begun to increase. If the balance between our staffing and the number of cases we handle continues to deteriorate, TAS is in jeopardy of becoming part of the IRS problem rather than the advocate for the solution, as Congress intended.

CONCLUSION

Compared to the IRS of ten years ago, the IRS of today is a more responsive and effective organization. On the customer service side, the IRS Restructuring and Reform Act of 1998 and the IRS response has brought about fairly dramatic improvements. On the enforcement side, the IRS has been stepping up its enforcement of the tax laws over the past five years, particularly with regard to corporate tax shelters and high-income individuals.

But the IRS can, and should, do better. To increase voluntary compliance, it should incorporate an ongoing taxpayer-centric assessment of taxpayer service needs into its strategic plans. It should conduct research into the causes of noncompliance and apply the resulting knowledge to IRS enforcement strategies, including those pertaining to the cash economy. Finally, it must have sufficient resources to move forward with its technological improvements, on both a short-term and a long-term basis.

APPENDIX: TAXPAYER SERVICE ISSUES

THE IRS NEEDS ADDITIONAL FUNDING TO ALLOW FOR THE IMPLEMENTATION OF NEW INITIATIVES DESIGNED TO IMPROVE TAXPAYER SERVICE

Over the past two years, in response to a directive from this Committee, the IRS—through its Taxpayer Assistance Blueprint (TAB) team—has engaged in extensive research into the needs, preferences, and willingness of taxpayers to use taxpayer services.[1] The TAB is a strategic document that contains a number of recommendations that, if implemented, will improve taxpayer service for many taxpayers. Many of the TAB recommendations focus on strengthening electronic service delivery options, with a focus on the irs.gov website. The goal is to provide increased service capabilities through the least costly electronic delivery channel, thereby reserving the more costly telephone and walk-in services for those taxpayers in need of additional assistance. As the IRS restructures the delivery of services and recognizes savings from increased efficiency, the IRS should reinvest these savings back into taxpayer service programs and initiatives to further improve on service delivery, including person-to-person and face-to-face assistance.

Moreover, the TAB report contains a number of recommendations that can have an immediate impact on the quality of taxpayer service. While the IRS will begin implementing these and other initiatives during fiscal year 2007, additional funding is needed in order to implement the proposed changes fully.

Online Taxpayer Tools.—During fiscal year 2008, the IRS is scheduled to launch the Internet Customer Account Services (I–CAS) platform. I–CAS will provide taxpayers with direct access to account information and services.[2] The first phase of the I–CAS rollout will provide taxpayers online access to account and return transcripts. The second phase will allow taxpayers to submit electronic versions of forms for change of address, disclosure authorization, and extension to file forms. With additional funding, future I–CAS capabilities could include explanation of account issues, movement of payments, and issue diagnosis and resolution.[3] Spanish versions of I–CAS and "Where's My Refund" are also planned for fiscal year 2008.[4] With additional funding, the IRS could expand to other languages.

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[27] Taxpayer Advocate Service customer satisfaction survey data for the period from October 2003 through September 2005, as collected by The Gallup Organization.

[28] Last year, TAS began using a new vendor to conduct its customer satisfaction surveys. We have not yet refined our new measure to make its results comparable to those achieved for years covered by the prior vendor.

[1] Internal Revenue Service, *The 2007 Taxpayer Assistance Blueprint Phase 2* (April 2007).

[2] Id. at 82.

[3] Id.

[4] Id.

Improvements in TAC Services.—During fiscal year 2007, the IRS is testing a Facilitated Self-Assistance Model (FSM) in 15 Taxpayer Assistance Centers (TACs) locations. FSM is designed to help taxpayers who have indicated a willingness to use alternative service channels, such as telephone or computer assistance, to learn how to effectively use those channels—thereby allowing TAC employees to focus on services taxpayers have indicated they want to receive in person. The FSM will provide taxpayers coming into a TAC with the option of using a self-assisted service to resolve a tax-related question. The TACs will be outfitted with workstations containing computers and telephones. This will allow taxpayers to access the irs.gov website or use the toll-free telephone line to receive assistance. TAC employees will be available to answer questions and provide assistance to taxpayers willing to use the workstations.[5] At any point during the process, the taxpayer will be able to request assistance from a TAC employee.

After completing their transaction using the workstation, taxpayers will be asked to complete a brief survey designed to assess the effectiveness of the FSM and satisfaction with the experience. The survey will also collect demographic user information to enhance the IRS's understanding of taxpayer needs, preferences, and behaviors. The goal of FSM will be to help some taxpayers become more comfortable using online and telephone alternatives to answer their questions or to obtain information through forms, publications, and other guidance. TAC employees can focus on those taxpayers who require face-to-face assistance or those services (such as payments or account resolution) that taxpayers cannot or are unwilling to address through alternate channels.

The IRS is also piloting a test to install payment kiosks in TACs. Currently, most TACs will accept cash payments from taxpayers who do not have, or are unable to obtain, a check or money order.[6] TAC employees must then convert the cash payment to a bank draft or money order.[7] This is particularly burdensome in smaller TAC offices where there are only one or two employees and one must leave the office in order to convert the cash payment. The IRS is testing the use of a kiosk located in the TAC that would allow a taxpayer to convert a cash payment into a money order without having to leave the TAC. The IRS will test these kiosks in two locations this year.

FSM and the kiosks have the potential to save both the taxpayer and the IRS time. If FSM and the kiosks prove to be effective, the IRS will likely need additional funding to install these features in all TACs.

THE IRS SHOULD NOT REDUCE CRITICAL TAXPAYER SERVICES

The TAB report puts forth a number of recommendations designed to improve taxpayer service. Although the report provides the IRS with valuable information regarding the needs, preferences, and willingness of taxpayers to use certain services, it is only a starting point. The IRS must continue its research efforts to determine how best to strengthen taxpayer services.

For example, the Taxpayer Advocacy Panel (TAP) has just conducted a survey that will shed light on the needs and preferences of those who visit a TAC. The methodology of the TAP survey differs from prior surveys in that it will attempt to survey taxpayers who attempted to visit a TAC but were unable to obtain assistance for such reasons as the line was too long or the TAC office was closed. The TAP survey gathered some basic demographic information, and it inquired about why the taxpayer was visiting the TAC and whether the taxpayer was satisfied with the service received. If the taxpayer did not receive any service, the survey will ask why none was provided. In addition, the TAP survey asked specifically why the taxpayer chose to visit the TAC instead of using a different IRS service and whether there were any services that were unavailable to them during their visit. The TAP survey results will provide the IRS with information useful not only in improving TAC services but in improving other taxpayer services as well.

As the IRS implements the TAB recommendations and conducts additional research, the IRS needs to maintain its current services until it is proven that the new service offerings are adequately meeting taxpayer needs. One of the effects of the IRS's focus on enforcement at the expense of compliance has been a reduction in taxpayer services that can have a dramatic impact on taxpayers.

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[5] The IRS designed the FSM model to ensure that taxpayer information is protected from unauthorized access and all taxpayers using the self-assistance options are provided with proper notification and information to make them aware that their computer usage is being monitored and recorded for research purposes.

[6] IRM 21.3.4.7.2, Cash Payments (Jan. 10, 2007).

[7] IRM 21.3.4.7.2.3, Converting Cash Payments (Jan. 10, 2007).

IRS Has Substantially Reduced the Number of Returns It Prepares at the TACs

The IRS historically has prepared tax returns for low income taxpayers at its TACs. Low income taxpayers generally qualify for the earned income tax credit (EITC), which is a refundable credit that caps out at $4,536 in 2006. Studies show that the average overclaim rate for EITC benefits is between 27 percent and 32 percent.[8] IRS personnel who prepare tax returns are trained to ask questions that minimize the likelihood of EITC overclaims and thus can save the government hundreds of dollars per return. Yet to free up resources for other program initiatives, the IRS has reduced the number of tax returns it helps low income taxpayers prepare in its walk-in sites by almost 40 percent over the past four years. The number of returns prepared dropped from 665,868 in fiscal year 2003 to 406,612 in fiscal year 2006.[9]

IRS data for tax years 2002 through 2004 suggest that EITC returns prepared by IRS TACs may be significantly more compliant than self-prepared and commercially prepared returns. As compared with TAC-prepared returns, Discriminant Function (DIF) scores were between 21 and 26 percent higher for self-prepared returns and between 25 and 31 percent higher for returns prepared by commercial preparers.[10] The DIF score is an estimate of the likelihood of non-compliance on a return. A higher score indicates a higher likelihood of non-compliance.

These findings are corroborated by examination results for EITC returns for these tax years. As compared with TAC-prepared returns, average audit assessments among EITC returns for tax years 2002–2004 ranged from about $640 to $1,300 higher for self-prepared returns and from about $820 to $1,300 higher for commercially prepared returns.[11] Similarly, a study conducted in 1996 that examined the relationship between IRS return preparation and compliance over a ten-year period showed that an increase in the number of returns prepared by the IRS correlates with substantial improvements in compliance among filers of individual returns. Indeed, taking into account the indirect effects of IRS return preparation, the study estimated the return on investment for each dollar the IRS spent on return preparation was 396:1.[12]

The IRS Is Declaring Increasing Numbers of Issues "Out-of-Scope".

In my 2004 Annual Report, I raised concerns about the increasing number of issues declared "out-of-scope" in TACs, because limiting the issues TAC employees are able to address reduces the level of service available to taxpayers.[13] For example, despite the number of taxpayers in certain states with taxable income from farming activities, I received a complaint at a "town hall" meeting in Fargo, North Dakota last year that questions about Schedule F, the form used to report farming income and expenses, are considered out-of-scope at IRS walk-in sites. I was astounded, but my staff has since confirmed that is the case.[14]

One of the reasons the IRS maintains a geographic presence is to allow taxpayers to obtain assistance with needs that may be different from the needs of taxpayers in other regions. Therefore, TAC out-of-scope questions could differ according to taxpayer needs by geographic region. Questions about farming may be appropriately considered out-of-scope in New York City—an area where complex financial reporting questions may be routine. In Fargo, North Dakota, it is fair to expect that farming questions are "ripe" for consideration.

TACs Are Not Adequately Responding to Emergency Transcript Requests.

Under current IRS policies, taxpayers who request a copy of a return transcript should have the transcript mailed to their address within 10 days.[15] If a taxpayer is requesting a hardship exception, she must provide verification to show why she is unable to wait the normal processing time to obtain her transcript. While these exceptions should be "rare" and require managerial approval,[16] the procedures for

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[8] Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns 3* (Feb. 28, 2002).

[9] Wage and Investment Operating Division, *Business Performance Review Fiscal Year 2006*.

[10] IRS Compliance Data Warehouse, Individual Returns Transaction File data for tax years 2002–2004.

[11] IRS Compliance Data Warehouse, Audit Inventory Management System data for tax years 2002–2004.

[12] See Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996).

[13] National Taxpayer Advocate 2004 Annual Report to Congress 12 (Most Serious Problem: Taxpayer Access—Face-to-Face Interaction).

[14] IRM 21.3.4–1, Scope of Services (Feb. 16, 2007).

[15] IRM 21.3.4.14.4, Tax Return and Tax Account Transcript Requests (Jan. 16, 2007).

[16] Id.

obtaining an exception are not operating as intended. One example comes from our Omaha office, where a taxpayer went to a TAC requesting a return transcript. The taxpayer was scheduled for surgery the next day and needed a copy of a transcript to prove he was financially eligible to receive assistance. The TAC employee indicated that this was not an emergency and the taxpayer would receive his transcript in two weeks. Luckily, the Omaha TAS office was able to immediately provide the requested transcript. The current IRS procedures for hardships are clearly not working. Taxpayers who are in need of transcripts for court proceedings, medical procedures, or student loans are being turned away and instead are coming to TAS for assistance. This reduction in taxpayer service is negatively impacting taxpayers and forcing them to turn to TAS for assistance that the IRS should be providing.

Small Business Outreach Has Declined.

IRS data show that self-employed taxpayers account for the largest chunk of the tax gap and indicate that the tax compliance rate for self-employed taxpayers runs at about 43 percent.[17] Much of the underreporting is deliberate, but some is not. For example, many small businesses are started by individuals who lack detailed knowledge of the tax laws and do not have the resources to hire tax attorneys or accountants. When they hire a few workers, they often do not realize that they are assuming tax reporting, tax withholding, and tax payment obligations, and they often do not understand enough about the details of complying with the requirements to do so with reasonable effort.

After enactment of the IRS Restructuring and Reform Act of 1998, the IRS developed a function known as Taxpayer Education and Communications, or "TEC." TEC was the IRS's outreach arm to small businesses to try to educate them about the complexity of their tax obligations. For 2002, TEC was named the Small Business Administration's agency of the year for what the SBA called its outstanding progress in creating an effective education and compliance assistance program for small business and self-employed taxpayers.[18] Yet in the name of achieving "efficiencies," TEC was "realigned" in February 2005 through a merger with other outreach functions and redesignated as "Stakeholder Liaison." Prior to the realignment, TEC had 536 employees. After the realignment, Stakeholder Liaison staffing included 219 employees.[19]

In my view, the reduction in TEC staffing will reduce tax compliance on the part of small businesses, result in more IRS audits of small businesses, and make more small businessmen and women feel like the government is playing "gotcha" with them by enacting complex requirements and then failing to help them understand how to comply.

IRS Telephone Assistors Are Answering a Reduced Percentage of Calls and Taking Longer to Do It

In 2003, the IRS answered 87 percent of all calls. This percentage dropped to 84 percent in 2006 and to 82 percent through March of this year's filing season. The average time it took the IRS to answer calls increased from 3.1 minutes in 2006 to 4.4 minutes so far this filing season.[20] While the level of service on IRS phone lines is substantially better today than it was in the 1990s, we are moving in the wrong direction.

THE IRS SHOULD MAKE IT POSSIBLE FOR TAXPAYERS TO PREPARE AND FILE THEIR TAX RETURNS ELECTRONICALLY WITHOUT PAYING A FEE

Electronic filing of tax returns brings benefits to both taxpayers and the IRS.[21] From a taxpayer perspective, e-filing eliminates the risk of IRS transcription errors, pre-screens returns to ensure that certain common errors are fixed before the return is accepted, and speeds the delivery of refunds. From an IRS perspective, e-filing eliminates the need for data transcribers to input return data manually (which could allow the IRS to shift resources to other high priority areas), allows the IRS

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[17] See IRS News Release, IRS Updates Tax Gap Estimates, (Feb. 14, 2006) (accompanying charts).

[18] See *Closing the Tax Gap and the Impact on Small Business*, Hearing Before the House Comm. on Small Business, 109th Cong. (Apr. 27, 2005) (testimony of John Satagaj, President and General Counsel, Small Business Legislative Council).

[19] IRS Small Business/Self Employed Division response to Taxpayer Advocate Service Information Request (Sept. 5, 2006).

[20] Government Accountability Office, GAO–07–673, *Internal Revenue Service: Interim Results of the 2007 Tax Filing Season and the Fiscal Year 2008 Budget Request* 20 (April 2007).

[21] See S. Rep. No. 105–174, at 39–40 (1998).

to easily capture return data electronically, and enables the IRS to process and review returns more quickly.[22]

In my view, the IRS should place a basic, fill-in template on its website and allow any taxpayer who wants to self-prepare his or her return to do so and file it directly with the IRS for free.[23]

Some representatives of the software industry have taken the position that such a template would place the IRS in the position of improperly competing with private industry or, worse, create a conflict of interest between the IRS's role of tax preparer and tax auditor.

This is nonsense. Since the inception of the tax system, there have always been two categories of taxpayers—those who are comfortable enough with the rules to self-prepare their returns and those who turn to paid professionals for assistance. In the paper-filing world, the IRS has always made its forms and instructions universally available without charge to all taxpayers, and those taxpayers who require help have always been free to seek the assistance of paid preparers.

Imagine that, shortly after the income tax was enacted, a large group of bricks-and-mortar tax preparers had launched a lobbying campaign to try to persuade Congress to prohibit the IRS from making forms and instructions available to the public on the ground that the availability of these materials improperly placed the government in the position of competing with private industry. Or on the ground that it created a conflict between the government's role as preparer and auditor. Congress almost certainly would have rejected such arguments as ludicrous. Yet those are exactly the same conceptual arguments being raised today by those who contend that the government's provision of a basic web-based, fill-in form to all taxpayers would undercut the private sector.

The answer to these arguments in today's electronic environment should be the same answer that Congress would have provided 80 years ago in a paper environment. For those taxpayers who are comfortable preparing their returns without assistance, the government will provide the means to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they are free to purchase one.

A brief personal anecdote. Although I prepared tax returns professionally for 27 years before I became the National Taxpayer Advocate and don't need assistance from others to prepare my return, my government salary places me above the income cap to qualify to use Free File products. To prepare my return electronically last month, I therefore purchased tax preparation software. When I completed preparing my return, the software program informed me that, to file electronically, I would have to pay an additional fee. Although I deeply believe that e-filing is best for both taxpayers and the IRS for a host of reasons, I resented the notion that I would have to pay separate fees to prepare my return and to file it, so I printed out my return and mailed it in.

I am hardly alone. IRS data shows that about 40 million returns are prepared using software yet are mailed in rather than submitted electronically.[24] This is a shame, because the practice delays the length of time for processing refunds, it requires the IRS to devote additional resources to entering the data manually when it receives the return, and it creates a risk of transcription error.

There is no reason why taxpayers should be required to pay transaction fees in order to file their returns electronically. A free template and free direct filing mechanism would go a long way toward addressing this problem and would result in a greater number of taxpayers filing their returns electronically. When taxpayers elect to use commercial software but print out their returns for mailing, the IRS should require software developers to convert data to 2D bar codes, so that all tax information can be scanned into IRS systems.[25] Both taxpayers and the government would stand to benefit from these improvements.

Senator DURBIN. I would like to now invite Mr. White and Mr. Powner from the Government Accountability Office to join us at the

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[22] The IRS Restructuring and Reform Act of 1998 directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007. See Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105–206, § 2001(a)(2), 112 Stat. 685 (1998). Although the IRS was not able to achieve this goal, we believe Congress should reiterate its commitment to seeing the IRS increase the e-filing rate as quickly as possible.

[23] See National Taxpayer Advocate 2004 Annual Report to Congress 471–477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

[24] IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

[25] More than 20 states currently use 2D bar-coding for personal income tax forms. See Federation of Tax Administrators compiled data http://www.taxadmin.org/fta/edi/ecsnaps.html.

panel. Although they did not have opening statements, they are prepared to answer questions. They have done extensive research on the operations of the Internal Revenue Service.

INTERNAL REVENUE SERVICE RECRUITMENT TOOLS

Mr. Brown, did you happen to see the article printed in the New York Times on April 16? It was by David, it appears to be, Schizer, dean at Columbia Law School, and he talked about the need for professional personnel at the IRS.

Mr. BROWN. I believe I did see this article, yes.

Senator DURBIN. It was interesting, some of the things he suggested, that in order to attract the kind of skill that we may need at the IRS to deal with the complexity of filings he said that perhaps we should do more in repaying student loans, student loan forgiveness.

First, could you comment on the need for that type of professional person and whether or not student indebtedness has become a factor?

Mr. BROWN. Indebtedness is a factor and I think he was referring to the chief counsel's side of the organization.

Senator DURBIN. That is right.

Mr. BROWN. Which is where our lawyers reside. Don Korb, who is our Chief Counsel, has taken a number of aggressive steps to attract top legal talent. Don can probably better address that than I could, but I used to work in the Chief Counsel's organization, so I am familiar with some of the things they do.

They offer bonuses when people come on. They accelerate the pay raises that people can get. It is difficult when you come out of law school. You tend to owe quite a bit of money, and our salary is not commensurate with what law firms offer. So it is hard, and with an increasingly complex Tax Code it is difficult to attract people of the quality we need.

Senator DURBIN. Are you using student loan forgiveness now to attract professional personnel?

Mr. BROWN. I do not know the answer. I will find out an answer and get back to you.

VOLUNTEER INCOME TAX ASSISTANCE

Senator DURBIN. Tell me about this, is it "VEE-tah" or "VIE-tah" program?

Mr. BROWN. "VIE-tah," volunteer income tax assistance.

Senator DURBIN. We hear from Mr. George that 56 percent of the returns are done accurately, are assembled accurately. That sounds like a pretty low number for a service being provided by our tax collecting agency.

Mr. BROWN. We are constantly trying to improve that number. As Russell has indicated, that number actually has improved to that point. I think you have got to recognize that the Code is quite complex. These people are volunteers. They are trained by us. We have clearly got to do a better job training them.

I would point out that there are errors on returns and there are errors on returns, and it sort of depends how fundamental the error is on the return. I think Nina would probably have an opinion

on this subject as well because Nina has looked very closely at this issue.

Senator DURBIN. I have always had a theory, incidentally. A few years ago my accountant in Springfield, Illinois, passed away and I decided as a lawyer who took tax courses in law school to just do my own returns. If every Member of Congress did their own personal returns, tax simplification would become a crusade on Capitol Hill. There is no doubt in my mind. What appears to be so simple is not, and we, guilty as charged, have created it in this situation.

FELONY FAILURE TO FILE

Let me ask you about this, the whole question of policy changes that you think will lead to more compliance. One of them was upgrading the penalty for willful failure to file taxes to a felony. Now, what percentage do you think that represents in terms of current noncompliance?

Mr. BROWN. Oh, I think that is an outlier, but it is more symbolic. Right now it is a misdemeanor. I worked for a number of years at the Justice Department as an attorney and, frankly, you cannot interest assistant U.S. attorneys in prosecuting misdemeanors. Perhaps in the drug area, but not in the tax area. They just do not want to spend time on that. They have too many cases competing on their docket.

What we are asking here is if you have willfully failed to file for 3 of the past 5 years, and there is an omission of more than $50,000, we are asking that failure be made a felony. We think that would lead to more compliance. I cannot tell you how much more, but there is symbolism there that we think is quite important.

LEGISLATIVE PROPOSALS

Senator DURBIN. What other changes are you proposing?

Mr. BROWN. Credit card reporting. If you ran a dry cleaning business and you take forms of payment as both cash and credit cards, we would like the aggregate dollar amount at the end of every year for your credit card receipts. That reporting will enable us to do two things. It may be that, given that we know from that industry, that payments are relatively divided evenly, 50 percent cash, 50 percent credit cards. We know not to audit you if it appears that you are in compliance. Or it would help us say, "there is something amiss here, please explain."

Senator DURBIN. Are there any other proposals that you think would have a significant impact on compliance?

Mr. BROWN. Well, we have a number. We have 16 of them. I think the basis reporting for security transactions is one that would be quite helpful. I can tell you from personal aggravation when I went to sell a mutual fund, it is difficult to calculate your basis. It is very difficult. I think that proposal helps both the consumer and it helps us, because the only information we have reported to us is the total sale price. We do not know what your gain is. So unless we start an audit, it is difficult to get to the proper number. So I think that would be helpful as well.

PREPARATION OF RETURNS

Senator DURBIN. I noticed here that, of course, the Internal Revenue Service is in competition with private companies when it comes to the preparation of tax returns. It appears that the number of people who utilize the services of the IRS is not increasing, may be decreasing some, in comparison to private companies. Can you give me some frame of reference there, percentage of those who are using private companies for preparation of returns?

Mr. BROWN. Our estimates are that 85 percent of people now either use a paid preparer or software to prepare their return. So you are down to about 15 percent left trying to navigate the system on their own or coming to us to use a volunteer outfit.

Senator DURBIN. What is your experience with those who do come in? Are they satisfied customers?

Mr. BROWN. I think they are by and large satisfied customers. I think that we have got over 12,000 sites around the country that do this now, 12,000 volunteers that do this for us now, and I think people are largely satisfied. They also serve segments of the population that may not be as fluent with computers and that sort of thing.

Senator DURBIN. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. I would like to make my statement a part of the record if I might, please.

[The statement follows:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Durbin for holding today's hearing.

The American people are no stranger to taxes or the IRS. The first income tax was enacted by President Lincoln and Congress in 1862, to help finance the Civil War. While this income tax was later repealed, today we have a tax code that is very cumbersome and in need of reform.

Recently, I had the pleasure of meeting with several constituents from Colorado. We discussed a very troubling occurrence involving the IRS and many landowners in Colorado. In many of these meeting I heard how frustrating and intimidating it can be to deal with the IRS. American citizens should not live in fear of their government. Taxpayers have a right to expect honesty and integrity in their dealings with the IRS.

According to the IRS' own mission statement, the IRS provides America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

For some time now I have been concerned by increasingly hostile IRS actions towards conservation easements. It would appear that the IRS is attempting to dramatically narrow the number of legitimate conservation easements by applying a standard that has been struck down by federal courts two different times.

Colorado is a national leader in conservation, and it is an issue of great importance to our state's economy and quality of life. It is also critical to our farmers and ranchers whose lands provide important agricultural products, wildlife habitat, water resources, and scenic vistas our state is famous for.

While I support investigation and enforcement of legitimate fraud, we must not target honest taxpayers, and Colorado's reputation should not be tarnished. There is a significant need for conservation easements in Colorado, and a few abuses should not end the charitable tax credit for everyone.

I have been in communication with the IRS over this matter for some months. Therefore, I will follow up with our panel in more detail during our question and answer period.

CONSERVATION EASEMENTS

Senator ALLARD. In Colorado one of the important programs that we have going there is conservation easements. It has been called to my attention that there has been a small amount of fraud. There is one person maybe, an assessor. But a large percentage of what is happening in Colorado I believe is probably not related to this limited fraud. Yet the reputation is spreading in Colorado that you are after the whole, meaning the Internal Revenue Service, is after the whole conservation easement process, period.

The last figure I got was 250 potential cases that were identified by IRS and now you are up to 290. So my question is, you continue to identify these individuals, but how many of these audits or how many of these 290 potential violations have had audits where you have closed it and delivered a revenue agent report?

Mr. BROWN. I do not know the precise number of how many have been closed. I do know that your number is correct on how many are underway. I do know that of the ones I have been briefed on, they have found some instances of abuse, not across the board, but they have found some instances of abuse.

Senator ALLARD. Yes. Well, some individuals that are involved, both ranchers and the environmental groups that have helped encourage conservation easements, have recognized that there was particularly one, a couple of guys or one guy that was involved with some problems. But if you look at their cases, they obviously were not areas where there was a conservation easement need. You could easily identify that.

I would encourage you to try and, let us get these resolved as quickly as possible and make a quick determination how extensive this is, because it is creating some problems. So I am getting complaints back in my office on that.

So the next question I have is, and this gets back to our conservation easement, what specific guidance does the Internal Revenue Service have in using to evaluate whether a conservation easement has conservation purpose?

Mr. BROWN. We publish forms and other booklets that offer tests. Generally it is a three-part test——

Senator ALLARD. Can I interrupt you there?

Mr. BROWN. Sure.

Senator ALLARD. Here is what I understand that you have stated on that issue. You say: "The presence of endangered species has never been a requirement for a conservation easement." Then you go further down and you state: "But the IRS also states endangered species are a factor that can demonstrate a conservation purpose."

So when you have individuals look at that, there is some confusion about how in the world you evaluate a conservation easement, because it seems to be a contradiction of fact there.

Mr. BROWN. Yes, and apparently when we did a briefing out there for people who are interested in taking these credits, the revenue agent was less than crystal clear, and I apologize for that. We will do our best to make sure that people do understand what is required here.

Senator ALLARD. Yes, because we have—well, one of the areas of concern is the sage grouse. Well, the sage grouse in some parts of Colorado has been classified endangered. Well, it's the Gunnison grouse, and then there is the regular sage grouse, a similar bird. But it has not been classified as endangered by—it is not on the endangered species list, but it is recognized as one of the 10 most endangered birds in North America by the Audubon Society.

So I guess the question comes up, well, how do you treat grouse habitat? So you can understand the vagueness on here, and the quicker we can get that clarified the more appreciative I think and the better compliance you will get from these processes that set up a conservation easement. If you could help us out on that I would appreciate it.

Mr. BROWN. We shall.

QUALIFIED APPRAISERS

Senator ALLARD. Now, one of the problems is qualified appraisers also. I had one individual come in to me who had a qualified appraiser, he is touted as being one of the best in Colorado for appraisals. The State of Colorado was involved in it. They did their own appraisal work and everything. Then the Internal Revenue Service comes back and they say the appraisal is not right.

So my question, so it brings up the question, are your appraisers truly qualified and do they meet the provisions that are defined in the Pension Protection Act—this was a bill signed into law by President Bush in August 2006—about following the uniform standards of professional practice? Do you have that qualified appraiser that visits with these folks?

Mr. BROWN. I believe all of our appraisers are qualified. I am going to go back and check and we would be happy to come up and brief you thoroughly on this.

Senator ALLARD. You may believe them qualified, but I want to see whether they meet the qualifications that are laid out within that particular provision.

Mr. BROWN. We will be happy to get you that.

Senator ALLARD. Okay, thank you.

So I see my time is running out here. So I will come back up with some other questions. Thank you.

Thank you, Mr. Chairman.

Senator DURBIN. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman, and thank you to the witnesses who are here today to testify. My opening remarks and my questions will be brief. I am here today to listen to your testimony. I think you are very knowledgeable. As we work to close the tax gap, I have questions about what the taxing authority has such difficulty in collecting the taxes that are owed. The power of the IRS, as they say, it is better to sin against God than it is the IRS because God forgives. I do not for one minute understand why the taxing agencies have so much trouble collecting taxes.

As Governor, I had a tax commissioner and I do not believe that we had the same level percentagewise of tax collection issues. So I have never understood it.

PRIVATE DEBT COLLECTION

But I want to touch briefly on a subject that is of interest to me. The IRS private debt collection initiative is obviously going to come up for discussion. I have long championed the effort to include that and to include within that program a preference for hiring service disabled veterans and other persons with disabilities to perform the debt collection work. In hiring in the Federal Government, there are various preferences offered by other agencies and I have worked with people from your office and my staff has worked with people from your office to try to put in place as part of the debt collection process a preference, a small preference by comparison, for firms that hire a certain number of individuals who are disabled, severely disabled.

What, if any, reservations do you have about including the disabled veterans preference program? I did get a letter saying that you were not sure, some time ago from someone in the IRS, saying that they were not sure that the process would be as good. I do not think they meant that disabled people could not do as good a job, but I did not understand what was meant, either.

Maybe you can give me your ideas about where the IRS is on this program now?

Mr. BROWN. Well, the program is done exclusively through phone calls.

Senator NELSON. I mean on the preference.

Mr. BROWN. Oh, on the preference. I am going to have to go back and take a look. I know that you have an interest in this and I do not know what the obstacles are. I cannot think of any at the moment, but I would have to go back and ask if there are any potential problems.

Senator NELSON. I cannot think of any at the moment either. But some of your staff did have some questions and some issues that we have tried to overcome and work through. I appreciate if you would—I have spoken to Secretary Paulson. I have spoken to Mr. Everson and I have worked with so many to try to get it done. I understand bureaucracy. Bureaucracy is full of "we bees"—we be here when you come, we be here when you go. And I want to move beyond that, to where we get a commitment to do the kinds of things that we should be doing.

Other agencies are able to do it. I do not understand the reluctance that I picked up along the way. Now, we have had some cooperation recently, but I have been 1½ years working to get that done and we have had to go around to get it into other legislation. But we want to make sure that there is no opposition to that or, if there is opposition, that we can understand what it is.

Mr. BROWN. Yes, sir, we will look into this.

Senator NELSON. Mrs. Olson—Ms. Olson, in your testimony you discussed the enormous amount of IRS resources that are devoted to supporting the private debt collection program. You say funding for the private debt collection initiative should be redirected to fund collection activity by IRS employees.

If they have not been able to do it before, what is the change where they can do it now?

Ms. OLSON. Well, sir, I covered in my annual report that I issued in December 2006 seven issues that the IRS could be doing better with the authority that they have right now, that do not raise the serious issues of privacy and perhaps violation of taxpayer rights or constitutionality of outsourcing tax collection.

I would note that my organization, the Taxpayer Advocate Service, has been a leader in the IRS in hiring disabled persons.

Senator NELSON. I did not mean to suggest you were not.

Ms. OLSON. No, but what I am saying is that the IRS I believe can do better in hiring disabled persons itself. Those are not positions that would be here today or gone tomorrow. There is a good side to the "we bees," which is that you have constancy in the position.

Senator NELSON. Absolutely.

Ms. OLSON. So I believe that the IRS, with a 2 percent or 3 percent real funding increase both in enforcement and taxpayer service, could be hiring many of these people and giving them secure and meaningful employment, without violating taxpayer rights or costing the Government money, 20 cents to 25 cents on the dollar. We do not cost that much.

Senator NELSON. Well, the cost per collection is paying money out of money that you otherwise do not have. So at the end of the day there is a net gain, unless you could do it better a different way.

One final thought. My time is running out here, but one final thought about this is that when it comes to privacy the issue generally of privacy has been handled at the State level because the States are outsourcing day in and day out and have had fairly good results in many cases. Foreign governments are today outsourcing. So outsourcing seems to have more legitimacy than I think you are giving it credit for. But if you could find a way to do what I am trying to do another way, I am interested. I can tell you that.

Ms. OLSON. Thank you.

Senator NELSON. Thank you, Mr. Chairman.

Thank you.

Senator DURBIN. Thank you, Senator Nelson.

OBSERVATIONS OF GOVERNMENT ACCOUNTABILITY OFFICE

Mr. White, what has the GAO found when it comes to the performance of the IRS as it relates to tax gap and efficiency? Can you give us your observations?

Mr. WHITE. Yes, Mr. Chairman. Let me talk about taxpayer service first. Over the last 8 to 10 years, we think we have seen a noticeable improvement in taxpayer service at IRS. If you look at things like telephone access, the ability to get through on the phones to a telephone assister, that is noticeably better than it was 8, 10 years ago. And the quality of the answers, the accuracy of the answers, is also noticeably better.

In addition, there are new types of service, especially on the web site, that IRS is providing. So there are features on the web site now, such as where is my refund, that taxpayers can use to get answers to questions about their specific tax situation, that in the past they had to wait in a queue to get through to a live telephone assister. One of the beauties of the web site is that it is available

around the clock 365 days a year. So that is the service side of the house.

On the enforcement side of the house, we think that the IRS has made some progress on enforcement. The direct enforcement revenue has gone up. Things like the national research program, which has been a large effort to better understand compliance, do research on compliance, so that noncompliant taxpayers could be better targeted in the IRS's operational audits, which has two effects. It brings in more money; it also reduces the burden placed on compliant taxpayers because they do not get audited.

On the other hand, the IRS's enforcement efforts are still on GAO's high risk list. We have got a $290 billion net tax gap out there and that has remained relatively constant in proportional terms for several decades now. So for that reason this area is still high risk.

Senator DURBIN. Mr. George, what would you say to that in terms of whether the IRS is aggressive enough on this tax gap and compliance issue?

Mr. GEORGE. Mr. Chairman, I would say that they are doing a good job, but they could certainly do a better job, and that all of the tools that would be helpful in achieving this goal are not necessarily within the possession of the IRS. As was pointed out by an earlier witness, the complexity of the Tax Code is a major component of the reason why the tax gap is as large as it is. If you had a very simple Tax Code, we believe that people would be more inclined to abide by it. But given the fact that they do not necessarily understand their requirements, they do not necessarily pay what it is that they owe.

As was pointed out by Mr. Brown, some of the proposals that the IRS has proposed would certainly help address the issue. For example, third party reporting. In the instance that he gave, it was related to the cost basis of stocks. That could be extended to various other components of the economy. Would it cost much more to do this? Most definitely. Would it achieve much more in terms of receipts to the Treasury? Most definitely. So this is a policy call that the Congress, working with the administration, needs to work out. But nonetheless, that among other ideas would certainly get to this issue.

PRIVATE DEBT COLLECTION

Senator DURBIN. Let me ask you, Mr. Brown, about this contracting out. This has come up a few times. I understand there are some private debt collection operations being used by the IRS. I understand that you terminated one company, Linebarger Goggans. Is that the name?

Mr. BROWN. Yes.

Senator DURBIN. Why were they terminated?

Mr. BROWN. At the 1 year mark of the contract, we had the right to unilaterally renew or terminate with regard to all three of the contractors. We had a high degree of confidence in two of them; we thought they were doing very, very well. We decided to continue with just the two of them. We thought that they were performing very well, honoring taxpayer rights, implementing the program the way we envisioned.

With the third one, it is not to say that they were failing in some regard. They just, in our view, were not performing at the same level as the other two companies.

Senator DURBIN. You or someone, I think it might have been your testimony or someone else, noted with some pride that the cost of collection was down from 46 cents per $100 to 42 cents over the last—the third lowest figure in the last 25 years. So tell me what role you believe that contracting out plays if your collection rates internally are improving at this rate?

Mr. BROWN. It is work we would not get to. I mean, that really is the point of the program, that these are cases that we would not get to with our staffing. If you were to give us more staffing, these are not the cases we would turn to next.

Senator DURBIN. Would these be the more complicated cases?

Mr. BROWN. No, in fact it is the opposite. These are simpler cases. These are cases that really are going to be what we call "full pays." The PCA can only do two things. They can either get the taxpayer to pay in full or they can get the taxpayer to pay in full over time.

Senator DURBIN. It sounds to me like those are the easiest ones for IRS employees to deal with.

Mr. BROWN. They are the easiest, but they are also—they tend to be smaller dollar and cases with a smaller degree of probability of success because of the age of the case and that sort of thing. We tend to work on cases that are more risky and higher dollar with our revenue officers.

Senator DURBIN. So what kind of cost comparison have you done between performing these services in house as opposed to contracting them out?

COMPARISON OF IRS TO PCA COSTS

Mr. BROWN. We are attempting to do that now and we should have some sort of good cost comparison later this year. I would note, though, that our employees have collection tools that are not available to the private sector. We have the power to file a notice of lien. We can file a notice of levy. We can levy on people's bank accounts. They do not have any of these authorities, so it is hard to do a complete apples to apples comparison.

Senator DURBIN. So do you think this decision on contracting out should be driven strictly on monetary terms? If the IRS can say to the taxpayers, "we can hire employees to do this work and bring back more revenue to the Government at a lower cost than doing it contracting out," then you should hire employees as opposed to contracting out?

Mr. BROWN. I think we have a large problem with the tax gap and this is a slice of money that we are not going to get to any time soon.

Senator DURBIN. With the current workforce.

Mr. BROWN. That is correct. But also, we can only hire so many people so fast. We have sort of a rule of thumb at the IRS, between attrition and what we call initiative hiring. If we go beyond 15 percent, we hurt our current year's performance and we tend to start losing control of our training. And the IRS is a bad place to lose control of the training of your employees.

Senator DURBIN. Do you know what the training is at some of the private collectors?

Mr. BROWN. Yes.

Senator DURBIN. Well, it turns out the Buffalo Times described the training process for employees at one of the companies as a 2-week training course. Is that what you think is adequate for the job of collecting for the IRS?

Mr. BROWN. No. The IRS, though, has collection tools that are not available. These people in the private debt collection outfits can only write letters or make phone calls and enter into what we call full pay agreements with the taxpayer. So they are good at locating taxpayers, calling taxpayers, and then trying to convince them to pay in full.

Senator DURBIN. I do not want to dwell on this, but I do want a direct answer. Will you compare the cost of hiring new employees to do this as opposed to contracting out?

Mr. BROWN. We are in the process of doing that, sir.

Senator DURBIN. Good. Thank you.

Senator Allard.

Senator ALLARD. Thank you.

I would like to follow up on that a little bit. You had two contractors who were performing very well, you were pleased. You had a third contractor who was not performing and you ended the contract. Now, if you have a civil—if you have three civil service employees and you have two of them that are performing, fine. But if you have one that is not performing, is it easy to dismiss them?

Mr. BROWN. It would depend on what you define as "not performing." Generally it is——

Senator ALLARD. You hit the problem right there. I mean, your response was it is very difficult because you cannot define it. I can tell you that I have had numerous complaints to us over the years, being in both the House and here, from nonperforming Federal employees. And you ask about disciplinary action: Well, we cannot do that, we cannot take care of them; they are protected by the civil service system.

So here you had a nonperforming entity. You took care of it with a contract and now you can replace it with a performing entity. It seems to me like there is a cost there that I hope gets figured into the figures. And I just wanted to make that point.

CONSERVATION EASEMENTS

I want to get back to what we were talking about with the conservation easements. We were talking about auditing. How many cases—okay. What are the methods the IRS is using to expedite the process of resolving the cases? I do not know as I got that question put to you. Do you have a response to that?

Mr. BROWN. Well, they are underway. It sort of depends. It is a complicated answer. But if it is a valuation question and it is an appraiser versus an appraiser, those tend to take longer. If it is a question of an interpretation of whether the easement was entered into for proper legal purposes, it is a more straightforward answer and those cases can be resolved more quickly.

Senator ALLARD. Okay. If you can get us some more specifics on that, I would appreciate it very much.

Mr. BROWN. We would be happy to.

[The information follows:]

The Service's engineering staff analyzed the sales of several Colorado properties encumbered with conservation easements to determine if commonalities exist among these properties. This analysis has been used as a guide in determining the accuracy of claimed valuations of the donated conservation easements.

The Service has also improved coordination between the Examination personnel and the Foresters and Engineering staff; as a result, revenue agents typically issue examination reports to taxpayers within two weeks from the date on which the agents receive the associated engineering valuation report. In addition, we have assigned some of our appraisers to work full-time on these cases. Where cases involve only a valuation issue, we are exploring all available administrative resolutions.

To better educate IRS personnel on the issues involved in conservation easements, we have implemented a web-based training module. We also continue to conduct workshops with field personnel and to provide technical guidance to those employees working conservation easement returns.

Senator ALLARD. Okay. Then I have been told by a constituent in Colorado that the IRS has been asking audited landowners for a second extension of the statute of appeals for their case. Can you confirm that?

Mr. BROWN. I am not aware.

Senator ALLARD. You will have to answer that question?

Mr. BROWN. We are going to have to answer that.

[The information follows:]

Our field personnel have requested statute extensions on 193 Colorado returns and second statute extensions on 45 of those returns. For the majority of returns for which we have sought only one extension, the statute of limitations will expire on April 15, 2008. Therefore, we expect to request second extensions for many of these returns. In addition, many returns require an extension while in Appeals or in the TEFRA Suspense Unit.

Requests to extend the statute—even a second time—are not unusual in valuation cases, because valuation issues often require more time to resolve than other issues.

Senator ALLARD. Okay, very good.

Well, that is pretty much—the final question: Do you have any expectations of when you might conclude those investigations that are going on in Colorado right now?

Mr. BROWN. As quickly as possible, and we will come back to you with a more detailed answer on that.

Senator ALLARD. I would appreciate that.

[The information follows:]

We do not have firm closure dates on any of the returns currently in process. Each property is unique and therefore we cannot merely apply positions taken in previous cases to subsequent cases without additional work. Rather, we must inspect, evaluate and consider each case on an individual basis, including conducting interviews with the donors and contacting third parties, as necessary. There are approximately 170 open cases that need appraisals of which 145 involve only a valuation issue. Of the 170 cases awaiting appraisals, we currently expect to complete appraisals for approximately 150 cases by March 2008 and the remaining 20 cases by August 2008.

INFORMATION SHARING WITH THE SSA

Senator ALLARD. Now, getting back, there was a question on identity theft by Senator Nelson from Nebraska. One of the problems I have run into is the sharing of information. Even though in the Homeland Security Department we tried to break down these stovepipes so there was some sharing of information, I have run across the situation, I have been informed that the Social Security Administration does not share their information with Homeland

Security. The question I have to you is that if there is fraud do they share that information with you, and do they communicate? Does the Social Security Administration communicate openly with the Internal Revenue Service on this?

Mr. BROWN. I am going to have to go back and get an answer. Social Security can share information with us. Going the other way, we have a prohibition in the Internal Revenue Code called section 6103 that prohibits us from sharing tax return information with other organizations without specified law enforcement purposes.

Senator ALLARD. I can understand that. But here is the problem that has been called to my attention by Secretary Chertoff and others, is that lots of times a taxpayer will not know that his ID has been stolen until a revenue officer knocks on his door maybe 3 or 4 months after his ID has been stolen—he did not know it—and he says, why are you not paying all of your taxes?

So I am trying to figure out why we cannot get an earlier notification to the taxpayer that there is some irregularity showing up on that ID using the Social Security number. Do you have any comment on that?

Mr. BROWN. Well, it does happen, there are some delays. Generally we wait for a return to be filed, and then if W–2s are coming in with the wrong Social Security number, indicating that you have got, for example, more income than just what your Senate salary is, we then have to unravel it. That generally involves contacting the taxpayer, having the taxpayer authenticate that he really is the proper owner of the Social Security number and somebody else is misusing it.

It generally is a process that takes several months to unravel. We need to do better at this.

Senator ALLARD. Now let us turn it around. If the Social Security happens to get, they have the same number come in and all of a sudden they find that there are two names on the same number, are they notifying you?

Mr. BROWN. We do receive information from Social Security on that.

Senator ALLARD. So that is getting shared with you, because I have been told that there might be some language in legislation somewhere that prevents that from happening.

Mr. BROWN. I am not aware of that, but we will get back to you.

Senator ALLARD. Research that.

Mr. BROWN. We will research that for you.

Senator ALLARD. Will you please, because if it is there I think that is a stovepipe we need to break down. I know there is this issue of identity and privacy, but if somebody has stolen your ID you have already lost your privacy and you do not want the victim to be victimized time and time and time again because of some provision here that prevents us from getting an early resolution on the victim and what has happened to the Social Security number.

Mr. BROWN. Yes, sir. We will get back to you on that.

[The information follows:]

We are not aware of any legislation that prohibits SSA from sharing information with IRS when they determine that the same SSN is being used by more than one individual. For example, the Combined Annual Wage Reporting System (CAWRS)

MOU between IRS and SSA states "SSA will convert the wage data to electronic format where necessary and furnish IRS with this data and validated SSNs and names where possible, or indicate which SSNs/names are not valid."

We generally find out that two taxpayers are using the same Social Security Number when a tax administration issue arises. Most of these cases are resolved in conjunction with the SSA through the Scrambled SSN process.

The Strategic Plan from the President's Task Force on Identity Theft briefly discusses the various laws that regulate the sharing of SSN information.

No single federal law regulates comprehensively the private sector or government use, display, or disclosure of SSNs; instead, there are a variety of laws governing SSN use in certain sectors or in specific situations.

In the public sector, the Privacy Act of 1974 requires federal agencies to provide notice to, and obtain consent from, individuals before disclosing their SSNs to third parties, except for an established routine use or pursuant to another Privacy Act exception [1]. A number of state statutes restrict the use and display of SSNs in certain contexts [2]. Even so, a report by the Government Accountability Office (GAO) concluded that, despite these laws, there were gaps in how the use and transfer of SSNs are regulated, and that these gaps create a risk that SSNs will be misused.[3]

PRIVATE DEBT COLLECTION

Senator ALLARD. Okay, thank you.

I guess my time is used up, Mr. Chairman.

Senator DURBIN. I would like to—there is one fact that I left out of this question or this conversation about private debt collection which is important. I think you have said, Mr. Brown, that the debts that are being collected by the private agencies are the easier ones; the more complicated debt collections are taking place within the Internal Revenue Service. Is that correct?

Mr. BROWN. Yes.

Senator DURBIN. And then the numbers you have given us are that it costs 42 cents to collect every $100 of tax revenue in these more complicated cases. Can you tell me how much the private debt collection companies charge the Federal Government on the easier cases for every $100 they collect?

Mr. BROWN. Well, the commissions to date have been running about 18 to 19 percent.

Senator DURBIN. So the comparison figures would be roughly 42 cents to $19 for every $100 collected?

Mr. BROWN. Well, again the comparisons are not pure. We have collection tools that they do not have available to them. They make outbound phone calls. Most of our calls are inbound. We get people's attention. We tell you we are about to levy on your bank account, you tend to call us. You tend to react. They do not have any powers other than the powers of persuasion by calling you and writing you letters.

Senator DURBIN. But you are suggesting then that that explains why they are charging 40 times as much as a person who works for you?

Mr. BROWN. Well, I think the premise of the program was that these were dollars we were not otherwise going to get to collect. We did not have sufficient resources to get to this slice of debt.

Senator DURBIN. I think we are back to the same circle. These are the easier dollars to collect, with employees you could collect them. You are contracting out and paying 40 times as much for

[1] 5 U.S.C. § 552a.
[2] See, e.g., Ariz. Rev. Stat. § 44–1373.
[3] *Social Security Numbers: Federal and State Laws Restrict Use of SSNs, Yet Gaps Remain*, GAO–05–1016T, September 15, 2005.

every dollar collected for the Treasury. So I just want to put it in that perspective because there was an image created of people who were at their desks not performing, where it turns out that the people who were at their desks are performing a lot better than the private collection agencies.

Mr. BROWN. Our employees do very well in terms of collecting money. I am not disputing that point. We think we are the finest in the world at collecting money.

PROTECTION OF PERSONAL INFORMATION

Senator DURBIN. Let me move to the issue of privacy, which Senator Allard has alluded to. Could you tell me about concerns that you might have over the protection of privacy information, personal information, of those who are dealing with the Internal Revenue Service?

Mr. BROWN. Yes. We are extraordinarily worried about this sort of thing. We have 52,000 employees that have laptop computers and we have a far-flung workforce that is out in the field every day attempting to collect taxes and undertaking audits of taxpayers. We have had a concerted effort and we have now managed to encrypt, fully encrypt, every laptop that is issued to an employee. There is no human element. If the laptop is lost, the information is now encrypted and cannot be accessed.

Senator DURBIN. If I am not mistaken, the inspector general has just issued an audit report. Can you tell us what you found about computers at the IRS?

Mr. GEORGE. Yes, Mr. Chairman. We issued this report last month, which found approximately 490 laptops and other personal devices were lost. We estimate those items contained approximately 2,800 personally identifiable information on taxpayers, and that is an estimate; that the procedures that were to be followed in terms of reporting the losses were not necessarily followed in many of the cases; and that this was again a statistical sampling, so we do not know the exact extent of the problem.

But the bottom line is it only takes one computer, laptop, BlackBerry, what have you, to truly cause disruption in someone's life.

Senator DURBIN. Mr. Brown, after you learned this what did you do?

Mr. BROWN. Well, this is what we did. We undertook this effort to encrypt every laptop and also to make sure that data exchanges with States and cities and that sort of thing were also secured properly.

ESTATE AND GIFT ATTORNEYS

Senator DURBIN. I would like to ask you a question if I might about, there was a disclosure recently. The administration announced its intention to eliminate the jobs of nearly one-half the lawyers at the IRS who audit tax returns for those subject to gift and estate taxes by October of last year. Did that happen?

Mr. BROWN. Actually what the IRS did was offer a buyout, and 86 estate and gift tax employees out of a workforce of several hundred did raise their hand and actually availed themselves of that buyout.

Senator DURBIN. The report we have is that these estate tax lawyers are responsible for overseeing audits of estate tax filings, which are the most productive and cost effective audits in the entire Internal Revenue Service system, generating approximately $2,200 for taxpayers in unpaid tax funds every hour that they go to work.

So how do you feel, or do you feel that the elimination of attorneys doing this audit work on estate taxes is going to help us narrow the tax gap and help us increase compliance?

Mr. BROWN. The average is about $2,200 per hour per audit. The median is about $200. Ten percent of the audits generate 90 percent of the work. Not every audit is a productive audit. The trick is to make sure we are working on that 10 percent and make sure we have very good coverage of those cases so that we garner the most dollars.

The idea is to take the 86 bodies and shift them to high income audits in other areas where we also tend to do very well in terms of dollars per hour.

Senator DURBIN. Better than $2,200 an hour?

Mr. BROWN. In some categories we do. Audits over $1 million, we tend to do as well.

Senator DURBIN. What is the signal? One time you tell us you want to make a felony out of willful failure and then the signal is we are going to have fewer auditors in certain divisions. What is the signal to those who are filing returns in those divisions?

Mr. BROWN. The signal is that we want to maximize the use of our resources and where 90 percent of your audits are not productive audits, we want to go to where we have places where we have what we call lower no-change rates.

Senator DURBIN. I think it is a mixed signal.

Mr. BROWN. I would have to disagree. I think that where only 10 percent of your audits are really counting, we want to go to a place where a much higher percentage is counting.

Senator DURBIN. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

Nina Olson, you have not answered any questions. I hate to see you get by with that.

ID THEFT AND TAXES

You have made in your comments that you wanted to maximize voluntary compliance. I look at your mission statement, which I think says a lot differently. And when you think about it, they mean a lot differently. Your mission statement that you have with the Internal Revenue Service says "Helping taxpayers to understand and meet the tax responsibilities by applying tax law with integrity in fairness to all."

This brings me around to, what happens to a victim when we have the identity theft and they are assessed this tax? Do you have them plugged into the computer and the computer keeps kicking out these notices that you owe the money, or is there some attempt to quickly resolve this problem that you have with the individual whose ID has been stolen? How is that handled?

Ms. OLSON. Well, first I would like to say my organization's mission is "Help taxpayers solve their problems with the IRS." So I have a sub-mission here.

Senator ALLARD. Okay.

Ms. OLSON. And many of our cases are, we have a fair number of identity theft cases. What generally happens is if someone else is using a Social Security number that belongs to the taxpayer, say on a W–2, that that W–2 will be processed through Social Security and eventually the IRS will get that information, and we will look to see whether those dollars show up on the true Social Security number owner's tax return. When we do not see those dollars there because the taxpayer did not earn them, they are not his or her dollars—somebody else did—we will send—we do not know that yet. We have to send that taxpayer a notice saying: You did not put dollars on that you should have; come in and talk to us.

The problem there is that we—until we do that notice, we will not know that there has been some act of identity theft. What then happens with the taxpayer unfortunately is sometimes they get caught in the IRS and IRS employees are not able to straighten out quickly who is the correct owner of the income of that Social Security number, and they are asked to supply lots of information.

Once we determine that this taxpayer owns that number, we still have to work with Social Security to make sure that, if it is even more confusing, that Social Security does not freeze that number and cause the taxpayer to use a temporary number. And we have no control over that.

In other instances—and I think this is something that——

Senator ALLARD. Can you communicate with Social Security?

Ms. OLSON. We do communicate with Social Security. On a case-by-case basis, IRS employees and Taxpayer Advocate Service employees communicate with Social Security on a case-by-case basis.

We have also been trying, the IRS Identity Theft Office has been trying to come up with a list of documents that either IRS will accept or that Social Security will accept, saying this taxpayer owns this number, or even giving us the authority to say, yes, we have looked at these documents, we think this is the taxpayer's own number, so we can move on.

Senator ALLARD. I would encourage you to move forward on that, because in 3 years and then all of a sudden to have somebody at your door. And then sometimes they spend lots of money just to get an accountant, to come back. And they do not work cheaply.

Ms. OLSON. Right.

Senator ALLARD. So it seems to me like somehow or the other it would be appropriate if we could give—if they have to hire professional help, for example, are they allowed to write that off as an expense or not?

Ms. OLSON. It would probably be for an individual a miscellaneous itemized deduction. I do not know how identity theft would come up in a business, but it could be a business expense.

RELIEF FROM ID THEFT EXPENSES

Senator ALLARD. That is what I am trying to figure out, if there is—maybe we need some legislation that would give those kind of individuals some relief.

Ms. OLSON. I think something that is very important that the IRS is working on is, once we know that somebody's number has been compromised we put an indicator on our accounts for future years, because often once the number is out there we are going to see W–2s coming——

Senator ALLARD. Yes, you are going to see more coming through.

Mr. GEORGE. Then we could at least, instead of sending an auditor out to that person or a letter out saying, you owe us money, saying we are seeing this happen again. I think we need legislative authority for that, to communicate in that way. But we can at least know internally that that taxpayer is not earning that money.

Senator ALLARD. I might have my staff work with you on that. That might be some common sense legislation that we can work on and maybe help those that are suffering from this crisis that occurs with identity theft if we can help them out.

I see my time just expired.

ELECTRONIC FRAUD DETECTION SYSTEM

Senator DURBIN. I would like to ask one last question. Mr. Brown, it appears that there was some lapse in terms of the systems that were being used, the electronic systems being used, and according to the inspector general $318 million in fraudulent refunds were issued in May of last year. Could you tell us what you are doing to recover that money?

Mr. BROWN. Well, we are not going to be able to recover the majority of that money. What you are referring to is the electronic fraud detection system that stops fraudulent refunds, what we deem fraudulent refunds, from going out. And once the money is out, it is extremely difficult to recover.

That system did not come up. We had a mistake there that should not have occurred and we have taken action both with the contractor and with our employees to make sure that does not happen again. The system did come up on schedule this year and it is functioning properly this year.

Senator DURBIN. But no effort was made to recover the money?

Mr. BROWN. There has been some effort, but it is extremely difficult to recover the money once it is gone.

Senator DURBIN. There was also the hiring of some consultants, as I understand it, to—perhaps the inspector general can comment on this. Are you familiar with it?

Mr. GEORGE. Not about the hiring of consultants, except for MITRE Corp., to look at what occurred in the past and to look at what they were attempting to do to remedy the situation.

But Mr. Chairman, this is symptomatic of a problem that has historically troubled the IRS. Most of their purchases and efforts to modernize their systems have been behind schedule, have cost more than were contracted for, and have failed to deliver what was promised. This, the EFDS, as they call it, electronic fraud detection system, was certainly an example of that.

Senator DURBIN. Mr. Powner, you have not had a chance to speak and I think this is your area of expertise. What would you say?

Mr. POWNER. Well, if you look at the EFDS system and what happened with that, it was a little bit different. We oversee the

business system modernization program for this committee and if you look at how this business systems modernizations are overseen from a project management and governance perspective, there is a lot of oversight that occurs. EFDS was actually flying under the oversight radar screen, so executives were not engaged on this system.

A couple things happened incorrectly. One is the system did not work when they deployed it, but you could not reactivate the legacy system. That is also a basic 101 misstep when you are deploying a new system. So there are several missteps that occurred here, not only with deploying the new one, but they could not reactivate the old system.

TECHNOLOGY IMPROVEMENTS AT THE IRS

Senator DURBIN. So step back from this particular case and tell me what your general impression is of the technology improvements at IRS?

Mr. POWNER. Well, in terms of the business systems modernization, that is an area where IRS has improved significantly over the years. Now, are there still concerns there? Yes, absolutely. If you look at the latest release of the CADE, which is really the linchpin for the modernization, we were late, the IRS was late on that, and there are cost overruns and schedule slippages that are still ongoing.

If you compare that historically, though, they have improved dramatically over the years. Now, are we still concerned going forward? Yes, we are concerned because there still is not the basic internal management capacity to manage the modernization effort that you would like to see, and the complexity is only going to increase over time.

Senator DURBIN. Mr. Brown, would you like to have the last word on that?

Mr. BROWN. I think the assessment is accurate. We have done a much better job over the years, but we have occasional slip-ups. This was one where we did not exercise proper management.

Senator DURBIN. Well, thank you for your testimony and your candor on that.

Do you have another question?

COLLECTION NOTICES FOR DELINQUENT DEBT OF $100 OR LESS

Senator ALLARD. Yes, Mr. Chairman, I have just one issue I would like to follow up on. This is the amount of collections where you send out notices where the amount owed is $100 or less. I think we sent you a request on this earlier and you said that was impossible to determine. Well, do you not have a computer that is capable of sorting out due amounts of $100 and less? Can you get us a total number on that?

Mr. BROWN. Yes. It is roughly 5.2 million notices were sent out last year for less than $100.

Senator ALLARD. 5.2 million, okay. Then what do you do with the $100 or less? Do you—these get turned over to collectors? Is that what they do? You send out a notice, I am assuming you send out a notice, and then how many respond on those?

Mr. BROWN. I do not have the precise numbers. We are not able to tell you how many dollars come in, but the vast majority. And remember, it is not——

Senator ALLARD. Most of them respond?

Mr. BROWN. Most, the vast majority respond. If they do not respond, if they are getting a refund in the following year, we would offset the refund. There are other ways to get the money.

Senator ALLARD. I see. Okay. Well, here is one of the things that I have had explained as a frustration. I have had taxpayers say, well, we—they claimed we owed a certain amount, it was under $100, it was $50 or $75, and to go to our accountant and have him hassle with the IRS just costs us money or it costs us to deal with it, so we are just going to pay it.

So there is, somehow or the other there is a balance there. I am trying to figure out where you feel that balance is.

Mr. BROWN. Many of the notices are generated by things like math errors. You simply added up the columns incorrectly. You added it, it came to $600 of income and the math actually should be $800 of income, and therefore you owe us another $50. So they are relatively straightforward things and most taxpayers I think see that and just comply.

Senator ALLARD. The more of them that use these computer programs, I would think math errors are less.

Mr. BROWN. We are very much in favor of those automated programs.

Senator ALLARD. Turbotax is not too difficult to use.

Mr. BROWN. They take the error rate down to——

Senator ALLARD. Maybe you need Turbotax, Mr. Chairman.

But those type of programs, yes.

Well, I am interested in knowing some statistics about how many you send out and how many respond on the first notice and what percent then—of those that are left, what happens to that after that.

Mr. BROWN. We will get you those, sir.

Senator ALLARD. Very good.

Mr. Chairman, thank you.

ADDITIONAL COMMITTEE QUESTIONS

Senator DURBIN. Thank you very much, Senator Allard.

Thanks to all the members of the panel. The record will be open for a week. There may be some questions submitted to you. I appreciate your testimony.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO KEVIN BROWN

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

TAXPAYER ASSISTANCE BLUEPRINT

Question. Improving taxpayer service is an important part of a comprehensive strategy to reduce the "tax gap" by helping taxpayers understand and meet their tax obligations.

On April 11, 2007, the Taxpayer Assistance Blueprint, Phase 2 was published. This Blueprint is the joint response of the IRS, the IRS Oversight Board and the

National Taxpayer Advocate to comply with a Congressional mandate for the development of a five-year strategic plan for the delivery of taxpayer service.

The Senate Report that established the five-year strategic plan directive for taxpayer service delivery provides detailed requirements for the content of the plan, including a strong urging that the IRS use innovative approaches to taxpayer services including mobile units and virtual technology.

Does the Blueprint include proposals for activities such as these?

Answer. The Taxpayer Assistance Blueprint (TAB) recommendations are grounded in extensive research regarding taxpayer needs, preferences, and behaviors. Factors that influence taxpayer's choice of service delivery channels include: the specific type of service sought, demographic characteristics, awareness of channels, access to channels, habit, and channel performance. TAB research indicates that taxpayers generally prefer self-assisted services, such as those found on the IRS website, most often for transactional tasks like obtaining a form or making a refund inquiry. Taxpayers prefer assisted services, such as those available through telephones or Taxpayer Assistance Centers, most often for more complex interactive tasks, like responding to a notice. Telephone lines and the IRS website account for approximately 85 percent of all channel contacts for the common service tasks surveyed. Investments that respond to this differentiated service approach in the two primary delivery channels will increase both taxpayer defined preference and value, and government value with efficiency gains. In contrast, the IRS Oversight Board 2006 Taxpayer Attitude Survey indicated that in response to the question "how likely would you be to use each of the following services for help with a tax issue?" 24 percent of taxpayers indicated that it was "very likely" that they would use a tax assistance van, compared to 58 percent for toll free telephone services and 51 percent for the web channels.

In view of this research, the TAB Strategic Plan focuses on enhancing the IRS website so it becomes the first choice of more taxpayers, while improving telephone service performance, increasing assistance to external partners (the source of the majority of prefiling and filing services), enhancing outreach and education to targeted populations, and improving the marketing of channel alternatives—specifically the electronic channel.

As noted below, virtual technology will play an increasingly important role in service delivery. The TAB envisions continued research on taxpayer expectations for and interest in virtual service delivery channels such as Voice over Internet Protocol and Text Messaging. Also, in recognition of the unique challenges presented by the face-to-face service environment, the TAB Strategic Plan recommends development of a Facilitated Self-assistance Model to provide taxpayers coming to a Taxpayer Assistance Center (TAC) the option of using self-assistance workstations to resolve their tax issues. The TAB Strategic Plan also calls for a TAC Geographic Footprint Initiative that includes a detailed process to analyze existing TAC locations for effectiveness in meeting service demands and using the process to make future investment decisions, including the relative value of mobile units or other alternative service delivery options.

Question. Please share some examples of innovative approaches the IRS is currently using or developing to meet taxpayer service needs.

Answer. The IRS has developed an effective business model for alternate service delivery to individuals challenged by income, language, age, or disability to meet their Federal tax obligations. The Stakeholder Partnerships, Education and Communication (SPEC) function supports over 300 community-based coalitions and thousands of local partnerships to extend outreach and assistance services. As a measure of this model's success, the United Way of America recently announced they were investing $1.5 billion over five years in this partner-based initiative. Virtual technology will play an increasingly important role in service delivery. TAB included a prospective virtual technology application, interactive web services, in its conjoint or "trade off" research. The Taxpayer Services Program Management Office, the function tasked with facilitating the implementation of TAB recommendations, will continue research on taxpayer expectations for and interest in virtual service delivery channels such as Voice over Internet Protocol and Text Messaging. In addition, TAB recommends enhanced alternate service delivery capabilities through increased support to its extensive community-based partner network and exploration of greater Federal Agency partnering and coordination to create shared service infrastructure.

DELIVERY OF INTERACTIVE TAXPAYER ASSISTANCE

Question. As an element of the Taxpayer Assistance Blueprint, the IRS recommended a migration strategy to move taxpayers away from Taxpayer Assistance

Centers (TACs) and toward electronic, self-assisted services. I understand the IRS plans to implement these Facilitated Self-Assistance Models in 15 selected sites, including two locations in my home State of Illinois. Under the model, taxpayers who come to the TACs for in-person help will be directed to in-house telephones and computers where they can access both the IRS website and phone assistors.

The National Taxpayer Advocate's Report to Congress for 2006 provides some data drawn from the IRS Oversight Board's 2006 Service Channel Survey. I think it elucidates the concern that migrating away from Taxpayer Assistance Centers (TACs) may be problematic. It states:

"Nearly 25 percent of taxpayers do not have Internet access, with more than twice as many taxpayers over 60 not having Internet access as those 60 or younger. Approximately 75 percent stated they were not secure sharing personal information via the Internet. Among taxpayers who have used IRS services in the last two years, about 45 percent of those who called IRS and more than 75 percent of those who visited the IRS stated that they would not use the IRS website."

How do you respond to concerns that migrating to self-assisted center may be laying the groundwork for an expanded effort to move persons away from face-to-face interactive contact and toward telephone and Internet access?

Answer. The Taxpayer Assistance Blueprint (TAB) recommendations are grounded in extensive research regarding taxpayer needs, preferences, and behaviors. TAB research indicates that taxpayers generally prefer self-assisted services, such as those found on the IRS Web site, most often for transactional tasks like obtaining a form or making a refund inquiry. Taxpayers prefer assisted services, such as those available through telephones or Taxpayer Assistance Centers (TACs), most often for complex interactive tasks like responding to a notice. Telephone lines and the IRS website account for approximately 85 percent of all channel contacts for the common service tasks surveyed. The TAB recommendation is to differentiate transactional and interactive service tasks within the TAC and satisfy them with effective, but different resources.

Question. Wouldn't a plan to scale back the number of TACs or replace them with self-help centers be an unwise cutback in customer service and a step backwards in achieving the goal of increasing compliance and shrinking the tax gap?

Answer. Rather than "self-help" centers, TACs would become portals where skilled and expensive staff resources would be applied to complex service issues and transactional tasks would be satisfied by effective, but less costly, web or phone applications. This differentiated approach conforms to growing private and public sector practices, responds to taxpayer defined value, addresses service performance in areas such as wait and service times and first contact issue resolution, increases service efficiencies, and has a potential positive impact on compliance.

The IRS plans to implement a limited deployment of the Facilitated Self-assistance Model at 15 locations in 2007 that will allow us to assess the effectiveness of this service delivery model. Adequate staffing, space, and technological infrastructure were considered in selecting these initial 15 locations. Demographic and geographic diversity were also analyzed to ensure adequate sampling for research and data gathering.

PRIVATE DEBT COLLECTION

Question. Is the private tax debt collection initiative generating greater returns at a lower total cost than the alternative of providing the IRS the additional resources it would need to collect the same tax debt on its own?

Answer. Overall, the IRS's Return on Investment (ROI) is about 4 to 1. ROI resulting from IRS enforcement programs ranges from $3 to $14 for every additional $1 invested, depending on the type of enforcement activity. For example, labor-intensive activities such as the Collection Field Function have lower ROIs, and automated activities such as Automated Underreporter have high ROIs.

We are performing a cost effectiveness study as recommended by GAO and in cooperation with the Taxpayer Advocate Service (TAS) in order to evaluate the program's impact on the collection of delinquent taxes and to serve as a comparison for program alternatives. We will issue the report from this study to GAO in August 2008. We project that the Private Debt Collection (PDC) ROI will range from 3.2:1 to 3.6:1 in fiscal year 2007 and from 4.0:1 to 4.3:1 in fiscal year 2008.

Question. If the initiative were eliminated, what steps could the IRS take to collect the tax debt that the private collection agencies were pursuing under their contracts and would sufficient resources be available to allow the IRS to take any (or all) of these steps?

Answer. If the program were eliminated, the IRS would continue to apply available resources to the highest priority work. Since these cases have already been through lower cost methods of collections at the IRS, they would remain unworked. The IRS would need a significant influx of resources over a number of years to be able to work enough inventory to get to these lower priority cases currently eligible for PCA placement. The President's Fiscal Year 2008 Budget request does not include funds to hire IRS workers to replace Private Collection Agency (PCA) employees should the Congress eliminate the program.

Question. What is the cost to the IRS of managing the initiative and processing cases that the private collection agencies cannot handle?

Answer. The projected fiscal year 2008 cost for administration of the PDC program is $7.35 million. We project that PDC will breakeven in April of 2008, including all start up costs. Of the $7.35 million, $5.84 million is for managing the initiative and consists of costs for the Referral Unit, Oversight Unit, Project Office, and Project Office contractors. The remaining $1.51 million is for IT costs.

The PCAs are not assigned cases that meet criteria outside of their authority. These cases have already been through lower cost methods of collections at the IRS, and would remain unworked and uncollected if not assigned to the PCAs. However, there may be instances where the taxpayers make a decision about their account that causes the return of the case to the IRS (e.g., Offer in Compromise, Innocent Spouse status, Insolvency, Disaster relief) and the IRS works on a case originally assigned to a PCA. In these instances, the returned PCA cases are processed according to IRM procedures in the appropriate function of the IRS. There are other situations where the IRS Referral Unit (RU) must work an account because the taxpayer opted out of working with the PCA or entered into an installment agreement that was beyond the PCA's authority to monitor. As of the end of April 2007, 37,689 cases were assigned to the PCAs and approximately 220 (0.6 percent) requested to opt out of the program or entered into an installment agreement beyond PCA authority. Given the small number of these requests, no additional costs are required beyond what has already been budgeted for the RU.

ELECTRONIC FILING

Question. Section 2001 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law105–206), specifies that it is the policy of Congress that paperless filing should be the preferred and most convenient means of filing Federal tax and information returns, it should be the goal of the Internal Revenue Service to have at least 80 percent of all such returns filed electronically by the year 2007, and the Internal Revenue Service should cooperate with and encourage the private sector by encouraging competition to increase electronic filing of such returns.

It is now 2007. What are the experiences with e-filing?

Answer. Based on the July 2006 results of our market research study called Findings From the 2006 Taxpayer Satisfaction Study for 1040 e-file conducted by Russell Research:

—Practitioner e-file is the term used for taxpayers who e-file their tax returns electronically through an IRS-authorized Electronic Return Originator. Online filing is the term used for taxpayers who e-file their returns online via their home computers either by using an online company or with software through a third party transmitter. Practitioner e-file and Online filing with software are maintaining high levels of satisfaction (82 percent and 83 percent respectively), but online filing with an online company is trending downward (from 83 percent to 74 percent).

—Three of the products (Practitioner e-file, online filing with an online company, online filing with software) continue to have a high number of user suggested improvements (simplify it and lower the costs).

—Non-user interest in practitioner e-file, the online filing products and Free File showed little year-to-year change, but long-term trend data indicates a hardening of non-user resistance to products and suggests that future usage gains may come in small increments.

—Non-users who were most resistant to adoption had generally negative impressions of the products in terms of their being better than other filing methods, being private and secure, being easy to use and being accurate.

—A gap analysis of attitudes toward e-file in general continues to show that lack of belief in e-file is clearly playing a role in its non-adoption among non-triers and even lapsed users. These segments do not accept e-file's benefits of accuracy, privacy/security or ease of use, and these are the attributes of a tax filing method that they value most.

—Another persistent barrier to the adoption of e-file is that not all practitioners offer or advocate the use of e-file at the same rate.

The Free File program is a free federal tax preparation and electronic filing program for eligible taxpayers developed through a partnership between the Internal Revenue Service and the Free File Alliance LLC—a group of private sector tax software companies. Free File is an online option available through the irs.gov website. Based on the July 2006 results of our Free File research study called Report of Findings From the 2006 Free File Cognitive and Behavioral Research conducted by Russell Research:

—Overall, users seem satisfied with Free File, with high intent to re-use (94 percent) and recommend (97 percent), high ratings of overall ease of use (94 percent) and low suggested improvements (30 percent).

—Free File's convenience appeals to them most with cost being the secondary driver.

—Other Free File program diagnostics results tell us that the site is generally easy to navigate (96 percent), that users have confidence in the security of their tax information (96 percent), and that it's easy to select a company at the site (94 percent) with high intent to use the same company next year (91 percent).

Question. What percentage of taxpayers in this filing season are submitting returns electronically?

Answer. Per IRS's Research, Analysis, and Statistics (RAS) Weekly Tracking Report for individual income tax returns for the week ending May 4, 2007, of the 127.3 million total individual returns filed, electronic filing (e-file) represented 76.7 million returns (60 percent) and paper represented 50.6 million returns (40 percent). Of the 76.7 million electronically filed returns, 54.7 million (71 percent) were e-filed by practitioners and 22.0 million (29 percent) were e-filed online. Of the approximately 95 million taxpayers who are eligible to use the Free File program in the 2007 filing season, 3.8 million actually used it. Numerous studies show taxpayers select a tax preparation "channel" (e.g. self-prepared, paid prepared, etc.) based on personal preferences and won't change. The current e-file rate of 60 percent is 3 percentage points higher than last year, at this point in time. The relative proportion of e-file returns is expected to drop to 58 percent by the end of the year as more returns with extensions are filed on paper.

Question. What efforts can be taken to increase the level of electronic filing?

Answer. The IRS's e-Strategy for Growth outlines plans to reduce taxpayer burden and continuously grow the e-file program. Key strategies include:

—Make electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer them to calling and mailing.

—Substantially increase taxpayer access to electronic filing, payment, and communication products and services.

—Aggressively protect transaction integrity and internal processing accuracy.

—Deliver the highest quality products and services as promised.

—Partner with states and other governmental entities to maximize opportunities to reduce burden for our common-customer base.

—Encourage private-sector innovation and competition.

Question. What are the impediments that have hindered attaining the goal set nine years ago?

Answer. In their 2005 annual report to Congress, the Electronic Tax Administration Advisory Committee has identified three major barriers to increasing electronic filing:

—Electronic filing must be faster, easier, and more accurate than paper filing and the initial experience must be positive.

—Electronic payments must be faster, easier, and more foolproof than paying by paper check and the first experience needs to be positive.

—Electronic services offered by the IRS must be faster, easier, and more efficient than paper, telephone or fax-based communications.

MANDATORY E-FILING BY CHARITABLE ORGANIZATIONS

Question. The IRS recently implemented measures requiring that certain tax-exempt organizations electronically file their annual returns, and many nonprofits recommend amending federal laws to require mandatory e-filing of all charitable organizations that annually file with the IRS. In particular, the Panel on the Nonprofit Sector, an independent group of nonprofit leaders convened at the encouragement of the Senate Finance Committee to make recommendations to Congress, recommended that tax laws be amended to enable the IRS to move forward with mandatory e-filing for all charitable organizations and that funding be authorized to support implementation of the initiative, and encourage more complete filings by

nonprofits and better oversight by the IRS. Organizations now required to file their returns electronically have needed to adjust from attaching documents to their returns to completing sections on the electronic returns.

What challenges has the IRS experienced in implementing e-filing, particularly from organizations accustomed to attaching documents to their returns?

What would the IRS need to do to implement broader e-filing requirements?

Would the funding levels proposed by the President for fiscal year 2008 permit the IRS to adequately serve groups now required to e-file and to move toward more extensive e-filing if approved by Congress?

Answer. The IRS worked closely with stakeholders and filers to communicate the business rules with regard to attachments in advance of the implementation of e-filing. Recognizing that our filer community often chooses to include "unrequested" information about their organization and program services, we worked with the software development community to ensure the creation of "General Explanation" pages that allow filers to include additional information that they believe is important. Moreover, the IRS has broadened the kinds of items that can be attached to e-filed returns to include such things as revised Organizing Documents and Articles of Dissolution.

The primary limitation on proposing a broader e-filing mandate is statutory. Section 6011(e) of the tax code provides that IRS can require e-filing only if the taxpayer is required to file at least 250 returns during the year. (This mandated threshold is for charitable organizations. Corporate taxpayers and partnership taxpayers have a different mandate.) The budget contains a proposal that all corporations and partnerships required to file Schedule M–3 would be required to file their income tax returns electronically. In the case of large taxpayers not required to file Schedule M–3 (such as exempt organizations), the Budget contains a provision to expand the regulatory authority to require electronic filing beyond the current 250-return minimum. That provision would reduce the legal barriers (the 250-return rule) that prevent enhanced e-filing.

The President's fiscal year 2008 budget request provides adequate funding for the IRS to serve groups now required to e-file. In addition, the budget requests funding for developing and deploying the capability for the modernized electronic filing application to accept and process a subset of the 1040 family of forms. The funding would also allow a significant advancement toward establishing the capability to accept and process all 1040-related forms in multiple phases as the IRS works to retire the legacy e-file system. The IRS's modernized electronic filing application has been designed and built to be scalable for additional volumes resulting from increased e-filings due to new and/or changed mandatory thresholds.

BUSINESS SYSTEMS MODERNIZATION

Question. During fiscal year 2006, the IRS developed a new IT Modernization Vision and Strategy for the Business Systems Modernization (BSM) program along with a 5-year plan to guide IT investment decisions through 2011. While this presents a positive first step towards defining the agency's future plans for the modernization program, it does not fully address GAO's recommendation to develop a long-term vision and strategy for completing BSM.

When does IRS anticipate completing this strategy, including establishing time frames for consolidating and retiring legacy systems?

Answer. Building a credible and comprehensive long-term vision and strategy to modernize the information technology of the largest and most complex tax administration system in the world is an iterative process that we are developing, institutionalizing and maturing over time in lockstep with our business partners. Our goals as part of our Modernization Vision & Strategy (MV&S) effort are to provide the vision, creativity, and a repeatable process to rationalize our investments in a way that we are now aligning with OMB's recommendations for Segment Architecture (Domain Architecture). In fiscal year 2005, our first year of this effort, we accomplished many foundational activities, and selected an integrated set of IT investments using sound investment processes across the primary tax administration domains (submission processing, manage taxpayers accounts, customer service, reporting compliance, filing and payment compliance, and criminal investigation).

During this past year, fiscal year 2006, the IRS improved and built additional capabilities to institutionalize the MV&S investment processes. We applied lessons learned to improve our development of technical solution concepts, added additional layers of functional and technical integration and sharpened our cost-estimation processes. In addition to covering the domains of tax administration, we added in a domain for IT security as well as a domain to cover our Internal Management Systems (to include our financial, human resource, and asset management applica-

tions). In parallel, we have been maturing our IT governance structure, and we have brought our governance committees into the MV&S process to oversee and approve the strategies, project proposals and prioritize at the domain level.

This year we are expanding the depth and breadth of our MV&S processes. A new functional area domain is being added to cover the provision of IT infrastructure products and services. In addition, we plan to complete a comprehensive architecture and strategy for one of the primary tax administration domains. This process will entail a comprehensive analysis of current processes and systems, target processes and systems over the next five years, transition strategies to achieve the targets and performance measures to be achieved. This initiative will address plans for consolidating and retiring legacy systems within that domain which you asked about in your question above. We then plan to complete the comprehensive architecture work for the remaining domains during fiscal year 2008.

It takes time and is very challenging to develop, communicate, and achieve organizational commitment to a vision and strategy for modernization that (1) addresses consolidation, transformation and retirement of hundreds of interrelated legacy systems; (2) incorporates modernized capabilities from new systems; and, (3) allows IRS to continue to provide systems for end-to-end tax administration that incorporate each years' new tax laws and policy. Previously the IRS has focused its IT modernization plans on dealing with the replacement of just key systems (e.g., CADE replacing the master files, the implementation of modernized e-file to both replace the legacy e-file system and handle additional forms types). The MV&S is about building the proper modernization plan for all of the IRS's IT, dealing with the more than 450 systems that support tax administration. The long-term goal is not to replace most of these systems, but, through concepts such as service-oriented architecture (SOA), to transform and streamline our IT environment over time while still being able to address new business needs that are identified through the MV&S process. Doing this right entails changes in a management paradigm that requires significant involvement from hundreds of people across the organization, entails embracing architectural and engineering concepts that have never been introduced in the past, and given the complexities, entails the use of an incremental approach. In addition, we must build and institutionalize capabilities within the IRS to make sound investment choices along the way so we can use our resources prudently. The good news is that the first two years of embarking on this effort have forged a much better working relationship between the business units of the IRS and MITS.

Even as we formalize and drive these plans ever deeper across the domains, one must realize that the plans must also be flexible to support significant change. Business requirements, tax laws and tax administration policy can change radically over time. One example would be in submissions processing and, in particular, e-file. We have a roadmap for implementing Modernized e-file (MeF) that has the IRS implementing MeF for all major form types by 2014. However, if the IRS is directed to implement a direct-file option for individual filers, it will significantly change the implementation approach and direction for MeF. Whether direct filing with the IRS should be done is a policy issue, but a decision such as that would have major impacts on our modernization strategy.

Lastly, your question addresses timeframes for consolidating and retiring legacy systems. These comprehensive architecture and strategies that we are developing for each domain will address timing.

I understand that the latest release of the Customer Account Data Engine (CADE), the system that is intended to replace the antiquated Master File processing system, was put into production in March, about two months later than planned.

Question. What was the impact of the delay on 2007 filing season processing?

Answer. Prior to CADE's deployment, we executed what is known as our Technical Backout Plan in which we automatically routed and timely processed tax returns for CADE-eligible accounts in the legacy master-file cycle. Since CADE is not a customer facing system, this recovery maneuver is not evident to the taxpayer, so this action does not increase processing time and the taxpayer received the same service this year that they have received in past years under the legacy master-file cycle. That said, unfortunately, there were approximately 20 million CADE-eligible taxpayers this year who could have received their refunds a few days earlier based on CADE-reduced cycle times had CADE been in production at the time they submitted their returns. There are no other effects to the taxpayer.

Question. What, if any, impact has the delayed release had on the planned functionality of CADE and on future releases of CADE?

Answer. The delay in delivering CADE Release 2.2 is having an effect on Release 3. While we have not completely finalized the changes in scope for the two sub-releases in Release 3, we are scaling back some of the functionality.

The priorities for Release 3 will be to maintain the functionality to enable the capabilities to be delivered in conjunction with Account Management Services (AMS), update CADE with any necessary filing season changes, address some technical upgrades and design issues that have been uncovered as we have run CADE in operation, and add functionality that will enable CADE to process additional tax returns (in particular, we will be adding capabilities for CADE to process returns with Math Errors and Disaster Area Designations).

While there will undoubtedly be less functionality increase in CADE Release 3 than originally planned, we believe that these steps we are taking to address the issues on CADE performance will enable us to "catch up" over the next few years, so we do not anticipate changing our planned retirement date of the individual master file in 2012.

Question. How does this year's delay, and possible delays in future releases of CADE affect other systems, including the Accounts Management System?

Answer. Based on our Technical Backout capability in CADE, this year's delay did not have any effect on other systems.

As your question notes, possible delays in future releases of CADE can affect other systems, most notably Account Management Services (AMS). We view maintaining alignment between the CADE and AMS programs a central challenge and source of risk for the BSM Program going forward. Development of these two major modernization initiatives requires a level of coordination and cooperative execution that is higher than the IRS has required so far in our modernization efforts. We recognized this challenge in our initial planning for the AMS program and have taken a number of steps to put in place the organizational structure, resources and approaches needed to assure that CADE and AMS are successfully delivered as a coherent set of capabilities.

For the Release 3 sub-releases of CADE (those that will be released in calendar year 2007), we have taken steps to ensure that functionality in CADE required for proper functioning of AMS is of high priority and will be delivered in those sub-releases. In particular, CADE is slated to deliver functionality that will support online address change in Releases 3.1 and functionality to support basic notices generation in Release 3.2. We do not anticipate any significant issues in delivering this functionality as part of these releases.

IRS WORKFORCE

Question. According to IRS data, while the number of employees at the IRS has decreased by almost 20,000 since 1995, the number of managers who supervise these employees has increased over this same period. During the period between 2000 and 2005, the number of frontline bargaining unit employees, decreased by 4,756, a decrease of 5.1 percent. During that same time, the number of managers and management officials increased from 12,514 to 12,684, an increase of 170.

Why does the IRS need more managers today than it needed six years ago when it now has 4,700 fewer front-line employees?

How many enforcement dollars and impact could 170 managers generate if they were assigned inventories?

Has the IRS considered returning any managers to front-line work?

Answer. A review of IRS staffing for January of each year shows that while there was an increase in the number of managers and management officials between 2001 and 2002, since 2002 the number of employees in this category has steadily decreased. An updated snapshot of the IRS staffing shows a 5.4 percent decrease in the number of managers/management officials from January 2001 to January 2006. The current alignment of managers and employees has provided the appropriate focus to allow for increased enforcement revenues of nearly 40 percent from $33.8 billion in 2001 to $47.3 billion in 2005. Audits of high-income taxpayers—those earning $100,000 or more—topped 221,000 in fiscal year 2005, the highest number in the past 10 years. Total audits of all taxpayers topped 1.2 million last year—a 20 percent jump from the prior year.

NARROWING THE "TAX GAP" AND MISCLASSIFICATION

Question. I am concerned about the misclassification of workers in certain industries as independent contractors. Many of these workers should be correctly classified as employees and income reported on W–2 forms, not 1099 forms. This misclassification leads to the underreporting of self-employment taxes, which the IRS estimates accounts for $148 billion per year and 43 percent of the gross tax gap. Last year, the Senate Appropriations Committee, in S. Rept. 109–293, strongly urged the IRS to provide increased tax enforcement in industries where misclassification of employees is widespread. In 1984, the IRS reported that at least

15 percent of employers misclassified about 3.4 million workers as independent contractors with higher rates in several industries including construction.

Is it your sense that the practice of misclassifying workers as independent contractors has increased since then?

Answer. While we have not conducted a recent study, the Government Accountability Office (GAO) looked at this issue in its 2006 report, GAO–06–656, entitled, Employment Arrangements—Improved Outreach Could Help Ensure Proper Worker Classification. In this report, the GAO stated the number of independent contractors increased from 6.7 percent to 7.4 percent of the workforce from 1995 to 2005, and the number of independent contractors in the contingent workforce population rose from 8.3 to 10.3 million. The report also states that many workers are misclassified as independent contractors; however, no updated data was provided. Additionally, we have seen an increase in misclassification through our examination process and increased filings of Form SS–8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. If the taxpayer accurately reports income received, whether as employee or an independent contractor, there is little consequence for the Social Security trust funds. The tax rates on wages and salaries, on the one hand, and self-employment income, on the other hand, are virtually identical. For self-employment taxes, however, work-related expenses incurred by the worker are deductible whereas similar expenses are not deductible by an employee.

Question. Has the IRS prepared an updated estimate?

Answer. We have not prepared an updated estimate. We are in the process of considering the possibility of undertaking the necessary research.

Question. What enforcement resources are being devoted now or are planned in fiscal year 2008 to address this issue?

Answer. The IRS office with primary responsibility for employment tax noncompliance devoted 9 percent of its fiscal year 2007 workplan to worker misclassification and plans to increase examinations of misclassification issues to 34 percent of its overall audit plan in fiscal year 2008.

Question. You have described the 16 legislative proposals and 4 administrative proposals for closing the tax gap. Is this issue a component of those? If not, why not?

Answer. This issue was not included in these 16 legislative proposals or the 4 administrative proposals. However, the Administration's fiscal year 2007 revenue proposals did address the issue. In addition to 5 tax gap proposals, it provided for the Treasury Department to study the standards used to distinguish between employees and independent contractors for purposes of withholding and paying Federal employment taxes.

Question. Where does addressing this problem fit within your strategy for narrowing the tax gap?

Answer. In conjunction with the Treasury Department's tax gap strategy issued in September 2006, the IRS is developing a comprehensive strategy to address employment tax issues. This strategy will include the issue of misclassification of workers as independent contractors. However, the prohibition on general guidance on classification issues contained in section 530 of the Revenue Act of 1978 limits the Treasury's ability to provide guidance in this area.

SAFE HARBOR AND MISCLASSIFICATION

Question. Under Section 530 of the Revenue Act of 1978, the "safe harbor" provision, employers who "reasonably" misclassify their workers as independent contractors are protected against any liability for employment tax purposes. This includes any employer who can show that more than 25 percent of his industry classifies workers as independent contractors.

I understand that once an employer is covered by the safe harbor provision, the IRS cannot pursue the employer for unpaid employment taxes even in the future as long as the situation has not changed in their industry, even if they are actually misclassifying.

What is the impact of the "safe harbor provision" including the number of employers who qualify, the particular industries, the number of workers that represents, and the loss of revenue to the Federal treasury in the form of past and future liability?

Answer. While we are unable to quantify the exact impact of the "safe harbor provision," we know that employers that claim safe harbor provisions of Section 530 represent a subset of all worker misclassification. Section 530 applies not only to past years but also future years as long as the taxpayer continues to report the income to the workers as required and treat the workers consistently as independent

contractors. Increasing noncompliance in an industry has the effect of increasing the possibility that most taxpayers in the industry will qualify for the safe harbor provision. GAO conducted the last study in this area in 1989. In this study they reviewed a sample of IRS worker reclassification examinations and determined that 40 percent of the tax could not be assessed due to the safe harbor provision.

RECRUITMENT AND RETENTION: STUDENT LOAN REPAYMENT

Question. One of the biggest challenges facing Federal agencies is attracting and retaining well-qualified, high-performing employees. Student loan repayments are a valuable management tool to help agencies recruit highly qualified candidates into Federal service and keep talented employees in the Federal workforce.

Federal law (5 U.S.C. § 5379) provides agencies with discretion to establish and tailor a student loan repayment programs. Recently, OPM issued its annual report on the use of the tool across the Federal government last year. With each passing year, the use of this program continues to grow dramatically.

In fiscal year 2006, 34 Federal agencies provided 5,755 employees with a total of nearly $36 million in student loan repayment benefits. This represents a 31 percent increase over fiscal year 2005 in the number of employees receiving student loan repayment benefits and a 28 percent increase in agencies' overall financial investment in this valuable incentive. When compared to fiscal year 2002, agencies invested more than 11 times as much funding on student loan repayments in fiscal year 2006.

How many IRS employees are currently benefiting from the student loan repayment program?

What portion of the IRS' fiscal year 2008 budget proposal would be devoted to initiatives such as those suggested by Columbia Law School Dean David Schizer in his op-ed published in the New York Times on April 16, 2007? Are you willing to give serious consideration to his recommendations and provide a written evaluation to the subcommittee on the feasibility and cost of implementing these suggestions? By what date could that assessment be accomplished?

Answer. While the IRS has not yet implemented a Student Loan Repayment Program, we have found thus far that the lack thereof has not hindered our ability to attract well qualified, highly motivated employees through the use of various student employment programs. In fiscal year 2006, 93 percent of these student program hires were to front-line positions.

The Office of Chief Counsel, which hires the majority of the attorneys in the IRS, revamped its recruitment program a couple of years ago by conducting on-campus interviews at law schools throughout the country and increasing its visibility by having executives visit top schools. As a result, it has been very successful in recruiting law students for entry-level and summer-internship positions. This past year Counsel hired 36 entry-level attorneys and 25 summer legal interns. Over 3,000 law students and recent graduates applied for these positions. The applicants were highly qualified—over 70 percent of those hired last fall were in the top 30 percent of their class.

NONPROFIT ELECTION-RELATED ACTIVITY

Question. 501(c)(3) organizations are permitted to engage in voter education and outreach activities, but are strictly prohibited from promoting or opposing any candidate for federal office. I understand that during the 2004 presidential campaign season, the IRS examined more than 100 charities and churches, questioning whether they had engaged in prohibited, partisan political activities. As a result of the investigations, the IRS sought to ensure that the nonprofit community engaged in legitimate election-related activities. Concerns have been expressed that the timing of the IRS's investigation discouraged legitimate voter education and registration efforts. There were also allegations that the investigations were provoked by politically motivated complaints.

How does the IRS evaluate whether a complaint is legitimate or motivated by partisan politics?

Is it possible for the IRS to expedite investigations to ensure they do not have a chilling effect on legitimate election-related activities?

Looking ahead to the 2008 elections, what additional resources will the IRS need to ensure that charitable organizations understand and comply with restrictions on election-related activities?

Answer. In both the 2004 and 2006 Political Activity Compliance Initiatives (PACI), the IRS endeavored to intercede quickly in instances of alleged prohibited political activity and to educate the organizations to prevent potential future violations. As we noted in our report on the 2004 initiative, the PACI Referral Com-

mittee, comprised of three career civil servant employees with extensive Exempt Organization tax law experience, determined whether the information the IRS received as part of a complaint supported a reasonable belief that the organization may have violated the political campaign prohibition of section 501(c)(3) and, therefore, warranted further IRS action. While these procedures are designed to weed out those complaints that are not legitimate, oftentimes it is only after examination that the validity of the complaint can be determined with certainty. We also note that a complaint from a partisan source may nonetheless be valid.

The 2006 PACI included expedited timeframes for classification and case assignment. Because of the sensitivity of these cases and their highly factual nature, as well as procedural prerequisites (e.g., the church tax inquiry procedures), and in some cases the lack of cooperation from the taxpayer, it is not always possible to ensure the swift completion of these examinations.

On June 1, 2007, the IRS released two documents to help tax-exempt organizations avoid prohibited political campaign intervention activities that can result in the loss of their tax-exempt status. Revenue Ruling 2007–41 sets out 21 factual situations involving tax-exempt organizations, including churches, and various activities that may or may not constitute prohibited political intervention. Second, the IRS released its Report on the Political Activity Compliance Initiative for the 2006 election cycle. The 2006 report details the types and numbers of allegations, which are roughly equivalent to those found in the 2004 cycle.

In terms of funding, we believe the Administration's fiscal year 2008 budget request for the IRS, which includes a $15 million increase for Tax-Exempt Entity Compliance, will allow us to effectively serve the public, including in the area of prohibited political activity, and we respectfully request your support for it.

IMPLEMENTATION OF NEW NONPROFIT LAWS

Question. The Pension Protection Act of 2006, enacted last August, included what has been called the most sweeping legislation affecting tax-exempt laws since 1969. The IRS has already issued some guidance reflecting changes in the law; however, several aspects require additional guidance. Increased outreach and education will also be necessary to ensure that charities, many of which rely on voluntary staff and do not have tax professionals, are aware of the changes.

What additional resources will be required to develop and issue needed guidance and web-based tools, educate IRS staff about the new rules, and ensure that individual taxpayers and charitable organizations have the necessary information to comply with the new rules?

Answer. The IRS has been extremely proactive in its guidance and outreach efforts related to the implementation of the charitable provisions of the Pension Protection Act of 2006 (PPA). We have updated our webpage continuously to reflect the latest developments. We explained the PPA changes affecting exempt organizations and their contributors on a Tax Talk Today web cast; over 6,100 individuals viewed it. We continue to speak at numerous other outreach events for organizations involving the PPA changes. We educated our staff and the telephone call sites on the PPA changes so they can respond to taxpayer inquiries. We have begun to roll out a massive publicity campaign, directed especially to small organizations, concerning the new annual notice filing requirement, which is applicable to all small organizations that did not previously have a filing requirement.

We made numerous changes to the 2006 Form 990 to implement PPA changes. We conducted two phone forums to explain these changes. The phone forums were open to all, and over 500 practitioners participated; we subsequently posted the script on our website, along with frequently asked questions. We issued guidance immediately following PPA's enactment addressing issues of critical importance regarding donor advised funds, supporting organizations, and procedures for being recognized as a publicly supported organization. We recently issued guidance on the procedures for section 501(c)(3) organizations to make their Forms 990–T available for public inspection. We will issue additional PPA guidance and outreach in the near future. We also will assist the Treasury Department on PPA mandated studies.

Implementation of the PPA is important. We have devoted the resources required to issue all needed guidance in a timely fashion, and we intend to continue to do so until the act is fully implemented.

We believe the Administration's fiscal year 2008 budget request for the IRS, which calls for a $15 million increase for Tax-Exempt Entity Compliance, will enable us to effectively serve the public, including in the area of prohibited political activity, and we respectfully request your support for it.

EFFECT OF NEW NON-CASH CHARITABLE CONTRIBUTION RULES

Question. In 2004, Congress enacted new restrictions on charitable contributions of vehicles. Most recently, in 2006, Congress enacted new restrictions and reporting requirements on charitable contributions of clothing and household items as part of the Pension Protection Act.

Has the IRS seen any changes in the amount and/or type of deductions being claimed since passage of these new rules?

Answer. Internal Revenue Code § 170(f)(12) went into effect for vehicle donations after December 31, 2004. Our Statistics of Income Division (SOI) collects this type of data. However, data for the 2005 tax year (the first tax year where the change applied) has not yet been analyzed.

Question. Has the volume of taxpayer queries increased since enactment of the rules?

Answer. The Accounts Management Toll Free function experienced a 23 percent increase in inquiries on deductions in fiscal 2005 compared to fiscal 2004. Questions received on deductions cover over 26 topics including contributions. The data we collect does not allow us to provide specific evidence on whether the increase was attributable to vehicle donations. In fiscal year 2006 the deduction queries returned to a level comparable to fiscal years before 2005.

QUESTIONS SUBMITTED BY SENATOR BEN NELSON

Question. Do you support including a preference for companies willing to hire disabled veterans and other individuals with disabilities within the IRS Private Debt Collection (PDC) program?

Answer. The IRS is considering a strategy that would give a preference to Private Collection Agencies (PCAs) that employ disabled veterans and individuals with disabilities.

Question. Do you support an across-the-board hiring target for collection agencies within the PDC to create jobs for veterans and other persons with disabilities?

Answer. In the short term, it may be difficult for the IRS to achieve an across-the-board hiring target for all collection agencies within the PDC program. Setting a predetermined target could jeopardize the program. If we were unable to find a contractor who meets the requirements, we could not enter into any qualified tax collection contract. PDC companies are often located in rural areas where there is a population base that allows them to employ highly qualified people at a low cost. These same rural areas may not have a large enough population of severely disabled and veterans to draw upon to achieve a set goal.

Nonetheless, the IRS is considering an alternative strategy that could give a preference to PCAs that employ the severely disabled and veterans. We intend to revise our contract award determinations to provide incentives. The IRS intends to offer extra evaluation points for PCAs that employ a specified percentage of the severely disabled or veterans. We are still in the process of finalizing the Request for Quotations for the next contract and have not yet determined the required percentages or extra evaluation points. We believe that this will encourage the PCAs to hire the severely disabled and veterans to work IRS accounts without jeopardizing the PDC program.

Question. What obstacles exist which prevent the IRS from developing a veterans/disability preference program for the PDC?

Answer. The obstacle to a disability preference program based on a hiring target arises after the contract is awarded. The PDC program requires the use of long-term contracts with the PCAs. Preparing the PCA to process IRS cases requires a significant amount of time and resources by both the PCA and the IRS. The contract period must be of sufficient time to allow the PCA and IRS to recover their expenses. We have determined one year to be the minimum time period for a contract to be cost effective.

The IRS implied obligation under a preference program would be to terminate a contract with disability preference if the contractor failed to meet the agreed upon condition. If after contract award, a contractor, otherwise qualified, is unable to fulfill the agreement to hire the required quota of severely disabled for positions to provide contract services, the contract would have to be terminated for breach of contract. The cost to cancel a contract after 90 days would dramatically increase the cost of administering the PDC program. We believe that an incentive as described above will encourage the PCAs to hire the severely disabled and veterans to work IRS accounts without jeopardizing the PDC program.

Question. What amount of the fiscal year 2008 appropriation does the IRS plan to devote to the PDC program? (Or, as fiscal year 2008 appropriations are as-of-yet

unknown, how much has the IRS budgeted for administration of the PDC program in fiscal year 2008?)

Answer. The current projected fiscal year 2008 cost for administration of the PDC program is $7.35 million. We project that PDC will breakeven in April of 2008, including all start up costs. Of the $7.35 million, $5.84 million is for managing the initiative and consists of costs for the Referral Unit, Oversight Unit, Project Office, and Project Office contractors. The remaining $1.51 million is for IT costs.

Based on conservative projections for revenue, the program is expected to recoup all costs in fiscal year 2008 and is projected to generate between $1.5 billion and $2.2 billion in revenue over 10 years. In fiscal year 2008, we expect the PDC ROI will be between 4.0 to 1 and 4.3 to 1, once the program is in steady state.

Question. If the IRS is prevented from using any appropriated funds to administer the program, how will the IRS allocate the appropriations which otherwise would have gone to the PDC program?

Answer. If the IRS is prevented from using funds to administer the program, we would need to determine alternative applications for the funding. The staff in the Referral Unit, Oversight Unit, and Project Office would be absorbed into other collection activities. The remaining non-labor funds would be reprioritized against all agency requirements. The IRS will work with the Office of Management and Budget (OMB) to determine the most appropriate allocation of resources.

It is also important to note that if the program is eliminated, the IRS would continue to apply available resources to the highest priority collection work. Since the cases assigned to the PDC program have already been through lower cost methods of collections at the IRS, they would remain unworked. The President's fiscal year 2008 budget request does not include funds to hire IRS workers to replace Private Collection Agency (PCA) employees should the Congress eliminate the program. The IRS would need a significant influx of resources over a number of years to be able to work enough inventory to get to these lower priority cases currently eligible for PCA placement.

In addition, sec. 6306 of Title 26 (The Internal Revenue Code) allows the Secretary to retain and use up to 25 percent of the collections for collection enforcement activities of the Internal Revenue Service. Termination of the contracts would also cut off continued accumulation of the retained funds which can be used to fund other Tax Law Enforcement activities. The projected revenue, between $1.5 billion and $2.2 billion over ten years, would also be lost.

Question. If the PDC were repealed or de-funded, is there a detailed proposal, including cost and timeline estimates, to replicate the PDC within the IRS, or an alterative plan to collect the "inventory" of cases or the debt currently slated to be collected via the PDC?

Answer. No. The types of cases currently assigned to the PCAs would not be actively worked by the IRS if the PDC program were repealed or de-funded and funding for any alternatives are not assumed in the budget request. Due to the volume of higher priority work, there is no plan to replicate PDC within the IRS. These lower priority cases would remain unassigned.

QUESTIONS SUBMITTED TO NINA E. OLSON

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

Question. Improving taxpayer service is an important part of a comprehensive strategy to reduce the "tax gap" by helping taxpayers understand and meet their tax obligations.

On April 11, the Taxpayer Assistance Blueprint, Phase 2 was published. This Blueprint is the joint response of the IRS, the IRS Oversight Board and the National Taxpayer Advocate to comply with a congressional mandate for the development of a five-year strategic plan for the delivery of taxpayer service.

The plan includes a variety of specific recommendations to expand, simplify, standardize and automate services, and to improve and expand technology infrastructure. It also includes recommendations for increasing education and outreach to taxpayers, partners and IRS employees, and incorporating feedback into future service decisions.

When the recent Blueprint was issued, you labeled it a "much-needed first step to delivering this service in ways that meet taxpayer needs."

Where does it fall short? What additional steps do you consider critical to meeting taxpayer needs?

Answer. The Taxpayer Assistance Blueprint (TAB) lays out a comprehensive, laudable plan to improve taxpayer service over the next five years. Now, the critical

issue is how the IRS implements the plan. I believe the TAB is only a "first step" because the TAB report alone will not ensure that the IRS delivers service in ways that meet taxpayer needs. To improve taxpayer service, the IRS must maintain a commitment to improving assistance to taxpayers both now and in the future, and must be given the resources necessary to make the needed improvements.

The TAB also is just a "first step" because it focuses solely on individual taxpayers. The IRS should expand its focus to more comprehensively consider the needs of all taxpayers. For example, the IRS should use the TAB as a starting point and engage in similar efforts to improve services for Schedule C filers, large and small businesses, and tax-exempt organizations. Additionally, the IRS should begin to look at other areas that affect taxpayer service, including return preparers, submission processing, and the content of notices and publications.

The IRS also should continue the research efforts it began in preparing the TAB. The taxpaying population will continue to change and so will taxpayer needs. The IRS should commit to ongoing research related to issues such as taxpayer needs, the link between service and compliance, and barriers taxpayers face to using certain IRS services.

Question. I understand that the Blueprint was a product of a collaborative effort. Were there any aspects upon which you could not reach consensus that, as a result, were not incorporated in the publication?

Answer. The TAB was designed to reflect the collaborative efforts of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate. Throughout the development of the TAB, I personally participated in the TAB Executive Steering Committee meetings and decisions. I met personally with the members of the TAB team to discuss with them my views on the TAB and taxpayer service in general. I reviewed drafts of the TAB report and provided comments and feedback to the TAB team. Members of my staff worked closely with the TAB team both in monitoring the research and in drafting the report.

Throughout the TAB process, disagreements occasionally arose over the direction of the TAB report. These issues were discussed among the Executive Steering Committee members in order to reach an agreement. I worked tirelessly to ensure that the TAB report would reflect a taxpayer-centric perspective and that taxpayer needs would not be unduly sacrificed for the sake of administrative convenience. I also wanted to ensure that given the time allotted, the TAB report would not come to any conclusion on reducing or eliminating taxpayer services. Instead, I urged that the TAB propose a methodology to evaluate current services and make improvements to meet taxpayer needs based on the data collected through the TAB research efforts, while not reducing the services currently available. For the most part, I believe the TAB report reflects this approach.

As the IRS begins to realize cost savings as a result of providing more efficient and effective taxpayer service, I believe strongly that any savings resulting from those efficiencies should be reinvested in taxpayer service and not shifted to compliance. I also believe that the IRS should maintain its commitment to providing face-to-face services in the future, as stated in the TAB Guiding Principles.

Question. As an element of the Taxpayer Assistance Blueprint, the IRS recommended a migration strategy to move taxpayers away from Taxpayer Assistance Centers (TACs) and toward electronic, self-assisted services. I understand the IRS plans to implement Facilitated Self-Assistance Models in 15 selected sites, including two locations in my home State of Illinois. Under the model, taxpayers who come to the TACs for in-person help will be directed to in-house telephones and computers where they can access both the IRS website and phone assistors.

The National Taxpayer Advocate's Report to Congress for 2006 provides some data drawn from the IRS Oversight Board's 2006 Service Channel Survey. I think it elucidates the concern that migrating away from Taxpayer Assistance Centers (TACs) may be problematic. It states:

"Nearly 25 percent of taxpayers do not have Internet access, with more than twice as many taxpayers over 60 not having Internet access as those 60 or younger. Approximately 75 percent stated they were not secure sharing personal information via the Internet. Among taxpayers who have used IRS services in the last two years, about 45 percent of those who called IRS and more than 75 percent of those who visited the IRS stated that they would not use the IRS website."

How do you respond to concerns that migrating to self-assisted centers may be laying the groundwork for an expanded effort to move persons away from face-to-face interactive contacts and toward telephone and Internet access?

Answer. Throughout the development of the TAB, I advocated strongly to ensure that, as the IRS moves increasingly toward the electronic delivery of services, the Service remains aware of the needs of those taxpayers who may be unable or unwill-

ing to use self-assisted services. Many taxpayers face barriers in receiving assistance, particularly in using the Internet, and the IRS has an obligation to provide service to these taxpayers, including face-to-face service, as well as to help these taxpayers overcome the barriers.

The IRS is making an effort to move taxpayers away from face-to-face interaction and toward telephone and Internet services. This approach is appropriate for many taxpayers who are comfortable handling financial transactions by phone or over the Internet. However, the TAB's research studies showed that a certain percentage of taxpayers will continue to need face-to-face services. Therefore, I will continue to advocate that, even as many taxpayers move to electronic service options, the IRS must maintain face-to-face services as long as there is a segment of the population that still needs them.

Question. Wouldn't a plan to scale back the number of TACs or replace them with self-help centers be an unwise cutback in customer service and a step backwards in achieving the goal of increasing compliance and shrinking the tax gap?

Answer. At this point, I believe the IRS lacks the data necessary to determine whether it should reduce the number of TACs or replace existing TACs with self-help centers. Although the TAB report contains a significant amount of information regarding taxpayer needs and preferences, the IRS still has not completed enough research to evaluate the existing TACs.

An ongoing survey of taxpayers who visit TACs conducted by the Taxpayer Advocacy Panel, an advisory panel that operates pursuant to the Federal Advisory Committee Act, should provide valuable information regarding whether TACs are meeting taxpayer needs. This is the first survey that asks taxpayers who were turned away from the TACs what assistance they were seeking, and asks taxpayers who were served by the TACs whether they received the service they sought. With this data, the IRS can begin to determine whether it is offering sufficient assistance or whether it needs to expand both the nature and amount of its service offerings to meet taxpayer needs.

My goal is to work with the IRS as it evaluates the current placement of the TACs. The IRS needs to ensure that TACs are located in areas where taxpayers need and can use the services offered. By evaluating the location of the current 401 TACs, the IRS can identify areas in which moving a TAC may make it more convenient for taxpayers. Additionally, we may identify areas where the IRS should consider adding a TAC.

The Facilitated Self-Assistance Model (FSM) represents an important step forward as the IRS expands its efforts to deliver services electronically. FSM is designed to assist taxpayers who have indicated a willingness to use alternate service channels, such as the Internet and the telephone. If a taxpayer comes into a TAC to obtain a form and the TAC does not have the form in stock, FSM will allow the taxpayer to use one of the computer terminals provided and, with the assistance of a TAC employee, to print out the form he needs. In the future, the same taxpayer may wish to return to the TAC to obtain a form, or he may now feel comfortable navigating irs.gov to print out a copy of the form on his own. FSM will also provide additional information about taxpayer needs. In addition to conducting surveys of taxpayers who use the FSM work stations, the IRS will be able to monitor taxpayers as they navigate irs.gov. This information will identify areas where the website can be improved to make it easier for taxpayers to use. This type of real world testing is critical to improving irs.gov and making it more taxpayer-friendly.

I do not view FSM as a replacement for traditional face-to-face services provided in a TAC. Rather, I view FSM as a complement to existing TAC services. If the FSM pilot proves successful and the IRS is given the additional taxpayer service funding it needs, I am hopeful that workstations will be installed in all TAC offices. By rolling out FSM, our goal is to help some taxpayers become more comfortable using online and telephone alternatives. FSM has the potential to save both taxpayers and the IRS time and costs.

Question. As your report observes, "Until [these] barriers to Internet access can be addressed, eliminating the option of being able to call or visit the IRS means that these taxpayers would not be able to use the IRS website for the service they received, increasing the burden for these taxpayers to comply with their tax obligations." How serious is your concern? What are the implications?

Answer. My concerns are very serious. As I have stated previously, the overriding mission of the IRS should be to increase voluntary compliance. The IRS should make it as easy as possible for taxpayers to comply with the tax laws. As the IRS looks to move more taxpayers toward using electronic service delivery options such as the Internet, the IRS must consider why some taxpayers cannot use the Internet. One way this can be accomplished is through the current Facilitated Self Assistance pilot in the TACs. By observing how taxpayers use irs.gov to obtain needed services,

the IRS can potentially identify barriers to using the Internet and modify irs.gov in order to help taxpayers overcome these barriers.

While continued research into the barriers to using electronic services is necessary, it is also critical that the IRS continue to maintain telephone and face-to-face services for taxpayers who are unable or unwilling to use electronic services. The IRS cannot reduce or eliminate existing service delivery methods until research demonstrates that the available services are meeting the needs of all taxpayers. Moreover, it is my belief that there are many tax issues that cannot be resolved through electronic communication. That is, the conversation between the IRS employee and the taxpayer, whether on the phone or in person, is part of the resolution process. Thus, I cannot now envision a time when it would be appropriate for the IRS to eliminate or sharply curtail the availability of face-to-face services for taxpayers who seek them.

QUESTIONS SUBMITTED BY SENATOR BEN NELSON

Question. What amount of the fiscal year 2008 appropriation does the IRS plan to devote to the PDC program? (Or, as fiscal year 2008 appropriations are as-of-yet unknown, how much has the IRS budgeted for administration of the PDC program in fiscal year 2008?)

Answer. The IRS estimates that the PDC initiative will cost $7.35 million in fiscal year 2008.[1] However, this number does not include indirect costs such as the staffing the Taxpayer Advocate Service is devoting to oversight and casework arising from the PDC initiative. Moreover, the IRS reports that it will have spent about $71 million in startup and maintenance costs by the end of fiscal year 2007, again excluding indirect costs. As a result, the IRS projects that the initiative at this point has lost money and will not break even until April 2008.[2] It is not clear why the IRS is investing so much in an initiative that promises to return relatively little and that raises so many concerns regarding taxpayer rights, especially when the IRS could invest the same amount of money in its Automated Collection System (ACS) and generate a greater return on its investment.

Question. If the IRS is prevented from using any appropriated funds to administer the program, how will the IRS allocate the appropriations which otherwise would have gone to the PDC program?

Answer. If Congress prohibits the IRS from administering the PDC initiative, the IRS could apply its resources to ACS, whose employees perform work most analogous to the PDCs. In fact, ACS would likely generate a much greater return than the PDC initiative if provided the additional funding. For instance, it is estimated that the PDC initiative will cost $71 million on startup and ongoing maintenance expenses through fiscal year 2007.[3] If this $71 million were allocated to ACS, the Office of the Taxpayer Advocate has estimated that the IRS could bring in $1.4 billion, as compared to the $19.5 million brought in by the PDC initiative to date.[4] Even if the cost of the PDC initiative significantly decreases, as the IRS projects, the IRS would still likely be better off spending the PDC program costs on hiring more collection personnel. For example, if the IRS applied the $7.35 million (which is the PDC initiative's estimated cost for the referral unit, oversight unit, program office, contractors, and MITS for fiscal year 2008) to ACS, the IRS could collect about $146 million.[5] By contrast, the IRS PDC initiative is projected to bring in $88 million in gross revenue for fiscal year 2008.

Question. What is the estimate of the return on investment in terms of revenue collected from the alternative use of appropriated funds as mentioned in question

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[1] Internal Revenue Service, Filing and Payment Compliance Advisory Council (May 1, 2007) at 15.

[2] Data furnished by the IRS Filing and Payment Compliance Modernization Project Office (June 2007).

[3] Internal Revenue Service, Filing and Payment Compliance Advisory Council (May 1, 2007) at 15. These estimated costs include startup and ongoing maintenance from the PDC Project Office, oversight, administration, and IT costs from fiscal year 2004 projected through fiscal year 2007. These estimated costs do not include infrastructure assessments for any MITS costs or costs associated with TAS oversight or casework arising from the PDC initiative.

[4] The dollars spent on the PDC initiative could instead have been used to fund new ACS employees. We computed the fully loaded cost of an average ACS employee at about $75,000 (assuming GS–8, step 5). Based on IRS expenditures of $71 million, the number of new ACS employees that could have been funded by the PDC initiative (about 942) was multiplied by the current average dollars collected by an ACS employee per year (about $1.49 million) to estimate the revenue that could be collected by ACS in one year.

[5] Internal Revenue Service, Filing and Payment Compliance Advisory Council (May 1, 2007) at 15.

1 above? How does this compare to projections for fiscal year 2008 collections under the PDC program?

Answer. It is clear that the IRS can collect these liabilities more efficiently and effectively. In fact, the IRS openly acknowledges it can do better.[6] The Private Collection Agencies (PCAs) get a four dollar return for every one dollar IRS invests.[7] By contrast, IRS ACS personnel obtain an average return of $20 for every one dollar IRS invests in collecting tax liabilities. From the September 2006 inception of the PDC program through April 19, 2007, the PCAs collected $19.5 million in gross revenue. As noted, however, if the $71 million invested in the PDC initiative were instead invested in ACS, the IRS could bring in about $1.4 billion. Not only can the IRS get a better return, but IRS employees, although not perfect, receive significantly more training concerning taxpayer rights and are better equipped to work with taxpayers on resolving their tax debts.[8]

Question. If the PDC were repealed or de-funded, is there a detailed proposal, including cost and timeline estimates, to replicate the PDC within the IRS, or an alterative plan to collect the "inventory" of cases or the debt currently slated to be collected via the PDC?

Answer. If the PDC initiative is repealed, there are a variety of areas in which the IRS could invest that would generate a better return and benefit taxpayers. For example, the IRS could invest in ACS, including retraining some submission-processing employees whose positions are being eliminated due to the expansion of electronic filing and the consequent reduction in the need for manual entry of data from paper-filed returns. Those employees could work PCA-type cases as a stepping stone to more complex collection work. The IRS could design a system that would effectively identify the "next best case" to work and should invest in modernizing its technology. The IRS could use the funding to revise or develop collection measures, which will accurately identify the true age of its accounts receivable; develop realistic measures of collection "yields" that accurately identify recovery of potentially lost revenue; and improve communication to delinquent taxpayers concerning the accrual of penalties and interest on collection cases.[9]

In addition to funding ACS, there are several alternative areas in which the IRS could invest the funds currently being used to oversee the PDC initiative. For instance, the IRS has failed to fund the other two components of its Filing and Payment Compliance Project (F&PC). These components include plans to conduct analysis on a given collection case and allow it to be officially routed to the appropriate collection unit, whether the IRS automated call sites, IRS campuses, or the IRS collection field function. The full impact of this initiative is unclear since only the PDC component is funded. But I believe there are multiple superior uses for these funds that would produce better returns on investment at less risk to taxpayer rights.

Question. What is the estimate of the return on investment in terms of revenue collected from the alternative use of appropriated funds as mentioned in question 1a above? How does this compare to projections for fiscal year 2008 collections under the PDC program?

Answer. Overall, the IRS Return on Investment (ROI) is about 4 to 1. ROI resulting from IRS enforcement programs ranges from $3 to $14 for every additional $1 invested, depending on the type of enforcement activity. For example, labor-intensive activities such as the Collection Field Function have lower ROIs, and automated activities such as Automated Underreporter have high ROIs. It would be expected that the ROI for an "alternative use of funds" initiative would be consistent with that for enforcement programs and range from 3:1 to 14:1.

In fiscal year 2008, we expect the PDC ROI will be between 4.0 to 1 and 4.3 to 1, once the program is in steady state. We base this estimate on fiscal year 2008 gross revenue projections of $86 million to $127 million compared to operating costs

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[6] Testimony of Commissioner of Internal Revenue, Mark W. Everson, House Committee on Appropriations: Subcommittee on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, Fiscal Year 2007 Appropriations for the Internal Revenue Service (March 29, 2006).

[7] Testimony of United States Treasury Secretary, John Snow, in an exchange with Senator Robert C. Byrd, Senate Committee on Appropriations: Subcommittee on Transportation, Treasury and General Government, Hearing on Fiscal Year 2004 Appropriations for the Treasury Department, May 20, 2003.

[8] TAS also produced video training, including a 20-minute presentation by the National Taxpayer Advocate and a two-hour discussion by TAS personnel, that is required to be taken by all PCA employees about TAS, taxpayer rights, low income taxpayer clinics (LITCs), and procedures for referring TAS cases.

[9] For an in-depth analysis of current IRS collection strategy and recommendations for improvement, see National Taxpayer Advocate 2006 Annual Report to Congress at 80–82.

of approximately $5.84 million[10] in IRS costs and the average 18.5 percent payments to the PCAs.

ADDITIONAL STATEMENT FOR THE RECORD

Senator DURBIN. The statement from Colleen Kelley, referred to earlier, will be inserted into the record at this point.

[The statement follows:]

PREPARED STATEMENT OF COLLEEN M. KELLEY, PRESIDENT, NATIONAL TREASURY EMPLOYEES UNION

Chairman Durbin, Ranking Member Brownback, and distinguished members of the Subcommittee, I would like to thank you for allowing me to provide comments on the Administration's fiscal year 2008 budget request for the Internal Revenue Service (IRS). As President of the National Treasury Employees Union (NTEU), I have the honor of representing over 150,000 federal workers in 30 agencies including the men and women at the IRS.

IRS FISCAL YEAR 2008 BUDGET REQUEST

Mr. Chairman, as you know, the IRS budget forms the foundation for what the IRS can provide to taxpayers in terms of customer service and how the agency can best fulfill its tax enforcement mission. Without an adequate budget, the IRS cannot expect continued improvement in customer service performance ratings and will be hampered in its effort to enhance taxpayer compliance. I would like to applaud the Administration for acknowledging in its Fiscal Year 2008 Budget in Brief (page 65) that "assisting the public to understand their tax reporting and payment obligations is the cornerstone of taxpayer compliance and is vital for maintaining public confidence in the tax system." However, I was disappointed in the Administration for failing to request a budget for fiscal year 2008 that meets the needs of the Agency to meet its customer service and enforcement challenges. In fact, the President's budget anticipates a "savings" equal to nearly 1,200 full-time equivalent positions, including 1,147 in enforcement and taxpayer service programs.

Although it's widely recognized that additional funding for enforcement provides a great return on the investment, the Administration seems reluctant to request an adequate budget for the IRS. In addition, despite citing a lack of resources as the primary rationale for contracting out a number of inherently governmental activities, such as the collection of taxes, the Commissioner of the IRS has told Congress that the IRS does not need any additional funding above the President' budget request.

NTEU believes that Congress must provide the IRS with a budget that will allow the Service to replenish the depleted workforce, particularly with respect to enforcement personnel.

History has shown that the IRS has the expertise to improve taxpayer compliance but lacks the necessary personnel and resources. The President's own fiscal 2008 budget proposal trumpets the increased tax collections produced by IRS's own employees and cites the increased collections of delinquent tax debt from $34 billion in 2002 to $49 billion in 2006, an increase of 44 percent. Unfortunately, instead of providing additional resources to hire more enforcement staff, IRS personnel resources have been slashed in recent years resulting in a 36 percent decline in combined collection and examination function enforcement staff between 1996 and 2003. In addition, these staffing cuts have come at a time when the IRS workload has dramatically increased.

According to IRS's own annual reports and data, taxpayers filed 114.6 million returns in 1995. After a steady annual climb, eleven years later, the Service saw more than 132 million returns filed. Yet, between 1995 and 2005, total numbers of IRS employees shrunk from 114,000 to 94,000. Even more alarming is that during that period, revenue officers and revenue agents—two groups critical to IRS enforcement and compliance efforts—shrunk by 32 and 23 percent respectively. Revenue officers who collect large delinquent accounts went from 8,139 to 5,462 and revenue agents who do audits fell from 16,078 to 12,355. Unfortunately, instead of reversing this trend, the IRS has continued efforts to reduce its workforce and has moved forward

[10] Due to fluctuating costs, there may be additional costs incurred that would result in the actual ROI being closer to the low end of the range. The $5.84 million does not include MITS Maintenance costs which were included in fiscal year 2008 costs ($7.35 million) on a prior page.

with downsizing in several different areas which have targeted some of the service's most productive employees.

These include last year's reorganization of the Estate and Gift Tax Program which sought the elimination of 157 of the agency's 345 estate and gift tax attorneys—almost half of the agency's estate tax lawyers—who audit some of the wealthiest Americans. The Service pursued this drastic course of action despite internal data showing that estate and gift attorneys are among the most productive enforcement personnel at the IRS, collecting $2,200 in taxes for each hour of work.

The IRS decision to drastically reduce the number of attorneys in the estate and gift tax area flies in the face of several reports made to Congress by Treasury and IRS officials over the past few years, indicating that tax evasion and cheating among the highest-income Americans is a serious and growing problem. In fact, an IRS study found that in 1999, more than 80 percent of the 1,651 tax returns reporting gifts of $1 million or more that were audited that year understated the value of the gift. The study found that the average understatement was about $303,000, on which about $167,000 in additional gift taxes was due. This alone cost the government about $275 million. Consequently, it is difficult to understand why the IRS sought the elimination of key workforce positions in an area that could produce significant revenue to the general treasury.

In addition, the Service continues to move forward with its plan to close five of its ten paper tax return submission facilities by 2011. The IRS originally sought the closings of the five paper return submission centers due to the rise in the use of electronic filing (e-filing) and in order to comply with the IRS Restructuring and Reform Act of 1998 (RRA 98) which established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. But in their recent report to Congress on e-filing, the IRS Oversight Board noted that the IRS will fall well short of the 80 percent goal and urged Congress to extend the deadline to 2012. The report noted that in 2006 just 54 percent of individuals e-filed their returns, well short of the 80 percent goal. Furthermore, the report cited a decline in 2006 in the number of e-file returns received from individual taxpayers who self-prepared their taxes. And finally a recent GAO report on the 2006 filing season noted the year over year percentage growth in individual e-filing slowed to a level lower than any of the previous three years.

While overall use of e-filing may be on the rise, the number of taxpayers opting to use this type of return is not increasing as rapidly as the IRS had originally projected. Combined with the fact that almost a third of American taxpayers do not even have internet access and changes to the IRS Free File Program that are expected to increase the number of paper filing returns, it is clear that paper submission processing facilities are still necessary and that serious thought and consideration must be given before any additional closings are undertaken.

Mr. Chairman, it is clear that drastic reductions in some of the agency's most productive tax law enforcement employees directly contradict the Service's stated enforcement priority to discourage and deter non-compliance, particularly among high-income individuals. In addition, we believe these staffing cuts have greatly undermined agency efforts to close the tax gap which the IRS recently estimated at $345 billion. As Nina Olson, the National Taxpayer Advocate noted, this amounts to a per-taxpayer "surtax" of some $2,600 per year to subsidize noncompliance. And while the agency has made small inroads and the overall compliance rate through the voluntary compliance system remains high, much more can and should be done. NTEU believes that in order to close the tax gap, the IRS needs additional employees on the frontlines of tax compliance and customer service. In addition, we believe Congress should establish a dedicated funding stream to provide adequate resources for those employees.

NTEU STAFFING PROPOSAL

In order to address the staffing shortage at the IRS, NTEU supports a two percent annual net increase in staffing (roughly 1,885 positions per year) over a five-year period to gradually rebuild the depleted IRS workforce to pre-1998 levels. A similar idea was proposed by former IRS Commissioner Charles Rossotti in a 2002 report to the IRS Oversight Board. In the report, Rossotti quantified the workload gap in non-compliance, that is, the number of cases that should have been, but could not be acted upon because of resource limitations. Rossotti pointed out that in the area of known tax debts, assigning additional employees to collection work could bring in roughly $30 for every $1 spent. The Rossotti report recognized the importance of increased IRS staffing noting that due to the continued growth in IRS' workload (averaging about 1.5 to 2.0 percent per year) and the large accumulated increase in work that should be done but could not be, even aggressive productivity

growth could not possibly close the compliance gap. Rossotti also recognized that for this approach to work, the budget must provide for a net increase in staffing on a sustained yearly basis and not take a "one time approach."

Although this would require a substantial financial commitment, the potential for increasing revenues, enhancing compliance and shrinking the tax gap makes it very sound budget policy. One option for funding a new staffing initiative would be to allow the IRS to hire personnel off-budget, or outside of the ordinary budget process. This is not unprecedented. In fact, Congress took exactly the same approach to funding in 1994 when Congress provided funding for the Administration's IRS Tax Compliance Initiative which sought the addition of 5,000 compliance positions for the IRS. The initiative was expected to generate in excess of $9 billion in new revenue over five years while spending only about $2 billion during the same period. Because of the initiative's potential to dramatically increase federal revenue, spending for the positions was not considered in calculating appropriations that must come within annual caps.

A second option for providing funding to hire additional IRS personnel outside the ordinary budget process could be to allow IRS to retain a small portion of the revenue it collects. The statute that gives the IRS the authority to use private collection companies to collect taxes allows 25 percent of collected revenue to be returned to the companies as payment, thereby circumventing the appropriations process altogether. Clearly, there is nothing magical about revenues collected by private collection companies. If those revenues can be dedicated directly to contract payments, there is no reason some small portion of other revenues collected by the IRS could not be dedicated to funding additional staff positions to strengthen enforcement.

While NTEU agrees with IRS' stated goal of enhancing tax compliance and enforcement, we don't agree with the approach of sacrificing taxpayer service in order to pay for additional compliance efforts. That is why we were disappointed to see that the President's proposed budget calls for the elimination of 527 taxpayer services positions. NTEU believes providing quality services to taxpayers is an important part of any overall strategy to improve compliance and that reducing the number of employees dedicated to assisting taxpayers meet their obligations will only those efforts. The Administration's own budget proposal for 2008 notes that in fiscal year 2006, IRS' customer assistance centers answered almost 33 million assistor telephone calls and met the 82 percent level of service goal, with an accuracy rate of 91 percent for tax law questions. In addition, a recent study commissioned by the Oversight Board found that more than 80 percent of taxpayers contacted said that IRS service was better than or equal to service from other government agencies. And while these numbers show that IRS taxpayer services are being effective, more can and should be done.

Mr. Chairman, in order to continue to make improvements in taxpayer services while simultaneously processing a growing number of tax returns and stabilizing collections and examinations of cases, it is imperative to reverse the severe cuts in IRS staffing levels and begin providing adequate resources to meet these challenges. With the future workload expected to continue to rise, the IRS will be under a great deal of pressure to improve customer service standards while simultaneously enforcing the nation's tax laws. NTEU strongly believes that providing additional staffing resources would permit IRS to meet the rising workload level, stabilize and strengthen tax compliance and customer service programs and allow the Service to address the tax gap in a serious and meaningful way.

SPAN OF CONTROL

And while it is imperative that Congress provide the IRS with sufficient staffing resources, we also believe that the IRS should look at the management to bargaining unit employee ratio to find additional resources for increased frontline tax compliance efforts. As noted previously, while the number of employees at the IRS has decreased by almost 20,000 since 1995, the number of managers who supervise these employees has increased over this same period. If we just look at the period between 2000 and 2005, we see that the number of bargaining unit employees, the frontline employees who do the work, decreased by 4,756, a decrease of 5.1 percent. During that same time, the number of managers and management officials increased by 170, an increase of 1 percent. If the IRS decreased the number of managers and management officials at the same rate as it decreased its rank and file employees during that period, there would be 5.1 percent fewer managers and management officials or a savings of 808 Full time Equivalents (FTE's) that could be saved and redirected to the frontlines. While the IRS has previously cited concerns about the number of employees that would have to be taken offline to train additional frontline employees, we believe this training could be done with minimal dis-

ruption to current operations. One possibility would be to use the increasing number of managers and management officials to do the training. This would ensure that these employees are afforded the best possible training while allowing current operations to continue to run efficiently.

PRIVATE TAX COLLECTION

Mr. Chairman, as stated previously, if provided the necessary resources, IRS employees have the expertise and knowledge to ensure taxpayers are complying with their tax obligations. That is why NTEU continues to strongly oppose the Administration's private tax collection program, which began in September of last year. Under the program, the IRS is permitted to hire private sector tax collectors to collect delinquent tax debt from taxpayers and pay them a bounty of up to 25 percent of the money they collect. NTEU believes this misguided proposal is a waste of taxpayer's dollars, invites overly aggressive collection techniques, jeopardizes the financial privacy of American taxpayers and may ultimately serve to undermine efforts to close the tax gap.

NTEU strongly believes the collection of taxes is an inherently governmental function that should be restricted to properly trained and proficient IRS personnel. When supported with the tools and resources they need to do their jobs, there is no one who is more reliable and who can do the work of the IRS better than IRS employees.

As you may know, under current contracts, private collection firms are eligible to retain 21 percent to 24 percent of what they collect, depending on the size of the case. In testimony before Congress, former IRS Commissioner Mark Everson repeatedly acknowledged that using private collection companies to collect federal taxes will be more expensive than having the IRS do the work itself. The Commissioner's admission directly contradicts one the Administration's central justifications for using private collection agencies—that the use of private collectors is cost efficient and effective.

In addition to being fiscally unsound, the idea of allowing private collection agencies to collect tax debt on a commission basis also flies in the face of the tenets of the IRS Restructuring and Reform Act of 1998. Section 1204 of the law specifically prevents employees or supervisors at the IRS from being evaluated on the amount of collections they bring in. But now, the IRS has agreed to pay private collection agencies out of their tax collection proceeds, which will clearly encourage overly aggressive tax collection techniques, the exact dynamic the 1998 law sought to avoid. Furthermore, the IRS is turning over tax collection responsibilities to an industry that has a long record of abuse. For example, in 2006, consumer complaints about third-party debt collectors increased both in absolute terms and as a percentage of all complaints that consumers filed with the Federal Trade Commission (FTC). Last year the FTC received 69,204 consumer complaints about debt collection agencies—giving debt collectors the impressive title of the FTC's most complained about industry.

NTEU believes that a better option would be to provide the IRS with the resources and staffing it needs. There is no doubt that IRS employees are—by far—the most reliable, cost-effective means for collecting federal income taxes. As noted previously, the former IRS Commissioner himself has admitted that using IRS employees to collect unpaid tax debts is more efficient than using private collectors. In addition, the 2002 budget report submitted to the IRS Oversight Board, former Commissioner Charles Rossotti made clear that with more resources to increase IRS staffing, the IRS would be able to close the compliance gap.

This is not the first time the IRS has tried this flawed program. Two pilot projects were authorized by Congress to test private collection of tax debt for 1996 and 1997. The 1996 pilot was so unsuccessful it was cancelled after 12 months, despite the fact it was authorized and scheduled to operate for two years. A subsequent review by the IRS Office of Inspector General found that contractors participating in the pilot programs regularly violated the Fair Debt Collection Practices Act, did not adequately protect the security of personal taxpayer information, and even failed to bring in a net increase in revenue. In fact, a 1997 GAO report found that private companies did not bring in anywhere near the dollars projected, and the pilot caused a $17 million net loss.

Despite IRS assurances that it has learned from its past mistakes, two recent reports indicate otherwise. A March 2004 report by the Treasury Inspector General for Tax Administration raised a number of questions about IRS' contract administration and oversight of contractors. The report found that "a contractor's employees committed numerous security violations that placed IRS equipment and taxpayer data at risk" and in some cases, "contractors blatantly circumvented IRS policies

and procedures even when security personnel identified inappropriate practices." (TIGTA Audit #200320010). The proliferation of security breaches at a number of government agencies that put personal information at risk further argue against this proposal. These security breaches illustrate not only the risks associated with collecting and disseminating large amounts of electronic personal information, but the risk of harm or injury to consumers from identity theft crimes.

In addition, a September 2006 examination of the IRS private collection program by the Government Accountability Office (GAO) reveals that like the 1996 pilot, the program may actually lose money by the scheduled conclusion of the program's initial phase in December 2007. The report cited preliminary IRS data showing that the agency expects to collect as little as $56 million through the end of 2007, while initial program costs are expected to surpass $61 million. What's more, the projected costs do not even include the 21–24 percent commission fees paid to the collection agencies directly from the taxes they collect.

In addition to the direct costs of the program, I am greatly concerned about the potential negative effect that the private tax collection program will have on our tax administration system. In her recent report to Congress, the National Taxpayer Advocate voiced similar concern about the unintended consequences of privatizing tax collection. Olson cited a number of "hidden costs" that private tax collection has on the tax system including reduced transparency of IRS tax collection operations, inconsistent treatment for similarly situated taxpayers, and reduced tax compliance. Clearly the negative effects of contracting out tax collection to private collectors hampers the agency's ability to improve taxpayer compliance and will only serve to undermine future efforts to close the tax gap.

NTEU is not alone in its opposition to the IRS' plan. Similar proposals allowing private collection agencies to collect taxes on a commission basis have been around for a long time and have consistently been opposed by both parties. In fact, the Reagan Administration strongly opposed the concept of privatizing tax collections warning of a considerable adverse public reaction to such a plan, and emphasizing the importance of not compromising the integrity of the tax system. (Treasury Dept. Statement to House Judiciary Comm. 8/8/86). More recently, opposition to the private tax collection program has been voiced by a growing number of members of Congress, major public interest groups, tax experts, as well as the Taxpayer Advocacy Panel, a volunteer federal advisory group—whose members are appointed by the IRS and the Treasury Department. In addition, the National Taxpayer Advocate, an independent official within the IRS recently identified the IRS private tax collection initiative as one of the most serious problems facing taxpayers and called on Congress to immediately repeal the IRS' authority to outsource tax collection work to private debt collectors (National Taxpayer Advocate 2006 Report to Congress).

Instead of rushing to privatize tax collection functions which jeopardizes taxpayer information, reduces potential revenue for the federal government and undermine efforts to close the tax gap, the IRS should increase compliance staffing levels at the IRS to ensure that the collection of taxes is restricted to properly trained and proficient IRS personnel.

IRS AUDITS OF HIGH-INCOME INDIVIDUALS AND LARGE BUSINESSES AND CORPORATIONS

Mr. Chairman, the final issue that I would like to discuss is IRS enforcement efforts with regard to high-income individuals and large businesses and corporations. I previously noted the drastic staff reductions in the estate and gift tax division that occurred last year and will obviously hamper the Service's ability to achieve greater compliance from the wealthiest Americans. In addition, recent IRS data shows that IRS audits of high-income individuals have dropped dramatically over the past decade. The audit rate for face-to-face audits fell from 2.9 percent of high-income tax filers in fiscal year 1992 to 0.38 percent in fiscal year 2001 and then drifted down to 0.35 percent in fiscal year 2004. While the audit rate has rebounded somewhat in the last two years, it is still far below the level of the mid-1990's. These facts seem to directly contradict claims by the IRS that the Service's first enforcement priority is to discourage and deter non-compliance, with an emphasis on high-income individuals.

We are seeing similar troubling trends with respect to large corporations. While this issue has just started receiving public attention in recent weeks, it has long been of concern to IRS employees that believe recent IRS currency and cycle time initiatives are resulting in the premature closing of audits of large companies, possibly leaving hundreds of millions of dollars of taxes owed on the table. IRS data shows the thoroughness of IRS enforcement efforts for the nation's largest corporations—measured by the number of hours devoted to each audit—has substantially

declined since fiscal year 2002. IRS data also show that the annual audit rates for these corporations, all with assets of $250 million or more, while increasing in fiscal year 2004 and 2005, receded in 2006 to about the level it was in 2002 and is much lower than levels that prevailed a decade or more ago.

Although the number of the largest corporations is small, they are a very significant presence in the American economy. In fiscal year 2002, the largest corporations were responsible for almost 75 percent of all additional taxes the IRS auditors said were owed the government. By comparison, low and middle income taxpayers in the same year were responsible for less than 10 percent of the total.

Agency data shows that audit attention given those corporations with $250 million or more in assets has substantially declined in the last five years. In 2002, an average of 1,210 hours were devoted to each of the audits of the corporations in this category. The time devoted to each audit dropped sharply in 2004 and by 2006 the number of hours per audit remained 20 percent below what it was in 2002.

But what may be most disturbing is that according to IRS' own data, while the coverage rate of large corporation returns (identified as those with assets of $10 million and higher) increased in fiscal year 2004 and 2005, the number of audits for these corporations actually decreased in 2006. Clearly, the rationale the IRS is using to justify a reduction in time and scope of large corporation audits, that is, to allow for expanding the total number of companies audited is not working.

IRS officials have continued to point to a rise in additional tax recommended for each hour of audit as a sign that the policy is working, but most auditors know that this rise can be primarily attributed to the proliferation of illegal tax shelters which makes it easier to find additional taxes due.

Warnings about the potential negative consequences of such policy decisions were made by a number of IRS employees in a recent New York Times article and are not new. In fact, when the IRS first began limiting the time and scope of business audits through implementation of the Limited Issue Focused Examination (LIFE) process in 2002, the former chief counsel of the IRS said that the IRS' proposed reductions in cycle time of corporate audits would "virtually guarantee that IRS auditors would miss tax dodges, fail to explore suspicious transactions, or even walk away from audits that are on the verge of finding wrongdoing."

In addition, IRS employees have raised concerns about this shift in approach to the auditing of business tax returns since its implementation several years ago. Their concerns are multi-fold. Primarily, employees' feel that their experience and professional judgment is being ignored when the scope of audits is limited and cycle times are reduced. Revenue agents need flexibility to determine the scope of an audit and need the ability to expand the examination time when necessary. The men and women of the IRS that perform these audits are highly experienced employees who know which issues to examine and when more time is necessary on a case. But under current IRS policies, this is just not the case.

Mr. Chairman, we have heard directly from a number of our members about the detrimental effect this policy has had not just on efforts to ensure corporations are in full compliance, but also how this misguided policy is damaging employee morale. In one instance, an IRS agent with 29 years of experience, including 19 as an international specialist examining tax returns of large, multinational corporations was given an unreasonably short period of time to examine three tax years of a very large company. The agent reported being constantly harassed for refusing to further limit the scope of the examination beyond that which was set at the beginning of the audit, even though he had successfully completed two prior examinations of the same taxpayer in a timely manner. The employee knew the issues and how to examine them but also knew they would need more than the allotted time to complete his part of the examination. But, despite past successes, management refused to provide the employee with additional time to complete his portion of the audit and labeled the employee as uncooperative and not a "team player." Although the employee refused to compromise, he believed that other members of the examination team had been pressured into dropping issues which likely would have resulted in additional tax.

Mr. Chairman, in the face of a rising tax gap and exploding federal deficits, it is imperative that the agency is provided with the necessary resources to allow IRS professionals to pursue each and every dollar of the taxes owed by large businesses and corporations. Allowing these corporations to pay just a fraction of what they owe in taxes greatly hinders efforts to close the tax gap and is fundamentally unfair to the millions of ordinary taxpayers that dutifully pay their taxes. Only by increasing the overall number of IRS employees that do this work can the Service ensure that businesses and large corporations are complying with their tax obligations and that the tax gap is being closed.

CONCLUSION

It is an indisputable fact that the IRS workforce is getting mixed signals regarding its value to the mission of the Service and the level of workforce investment the Service is willing to make. NTEU believes that the drastic reductions of some of the IRS's most productive employees, reliance on outside contractors to handle inherently governmental activities such as the collection of taxes, and a shift in philosophy which focuses enforcement efforts too much on wage earners and not enough on high-income individuals and large businesses and corporations, only serve to undermine the agency's ability to fulfill its tax enforcement mission and hamper efforts to close the tax gap.

SUBCOMMITTEE RECESS

Senator DURBIN. The subcommittee stands recessed.

[Whereupon, at 4:17 p.m., Wednesday, May 9, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS FOR FISCAL YEAR 2008

WEDNESDAY, MAY 16, 2007

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 3:07 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Brownback, and Allard.

SECURITIES AND EXCHANGE COMMISSION

STATEMENT OF HON. CHRISTOPHER COX, CHAIRMAN

STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. Good afternoon. This hearing will come to order.

I am pleased to convene this session before the Financial Services and General Government Appropriations Subcommittee. Our focus today is on the President's fiscal year 2008 budget request for the Securities and Exchange Commission (SEC). In previous years funding for this agency was provided through the Commerce, Justice, and State, the Judiciary Subcommittee. It now has a new home in the Senate Financial Services Subcommittee.

I welcome my colleague Senator Allard who has joined me and others who may arrive. Appearing before the subcommittee this afternoon is the Chairman of the SEC, the Honorable Chris Cox. Welcome, Chairman Cox. Glad to have you here, my former colleague from the House.

The mission of the SEC is to administer and enforce Federal securities laws, to protect investors, and maintain fair, honest, and efficient markets. This includes ensuring full disclosure of financial information, regulating the Nation's security markets, and preventing and policing fraud and malpractice in the securities and financial markets.

The administration's budget proposal for fiscal year 2008 seeks $905.3 million for the SEC. This is a 2.7-percent increase, $23.7 million over the fiscal year 2007 spending level. The $905.3 million includes $30.3 million in carryover balances.

It is interesting and important to note that the entire amount of the SEC budget authority is derived from the collection of fees, fees that are collected and deposited in special offset accounts, available

to appropriators, not to the Treasury's general fund. As a result of these fee collections, no direct appropriations are used to fund the SEC.

The proposed funding level of $905.3 million is similarly structured: $648.5 million designated for enforcement, $59.4 million for regulatory function, $126 million directed to disclosure reviews and investor education, and $71.4 million for operations.

I would like to invite my colleague Senator Allard, if he would like, to make an opening remark at this point.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, thank you. I would like to make a brief remark if I might. I want to thank you for holding this hearing.

Currently the securities and financial markets of the United States are thriving and investors are enjoying the longest bull run in over 80 years. The Dow Jones Industrial Average has recorded 22 record closes since the start of the year and the S&P 500 is 24 points below its record close it set in March 2000. The Dow is no longer showing lingering effects of the 416-point drop it suffered on February 27 and the U.S. economy is continuing to expand and is adding jobs.

With more than one-half of American families investing in the securities market, it is vital to our Nation's economic health that we enjoy fairness, integrity, and efficiency in the marketplace.

I would like to take this time to welcome my good friend and former colleague, Chairman Cox, whose responsibility it is to uphold the SEC's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. I am used to seeing Chairman Cox testify before the full Senate Banking Committee, but I welcome him here and this opportunity to discuss important issues involving the SEC.

We will be holding a hearing tomorrow, Mr. Chairman, in the authorizing committee on the consolidation of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) regulatory functions. I would like to thank you, Chairman Cox, for allowing a member of the SEC to testify in front of that committee on this matter.

Again, Mr. Chairman, thank you for holding today's hearing. I look forward to hearing Chairman Cox's testimony and working with him and the SEC as a member of this subcommittee and as the ranking member of the Securities and Insurance and Investment Subcommittee.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Allard.

I want to just join in noting that the stock market has been doing very well and I hope there is nothing we will do here today that will change that.

I turn now to Chairman Cox for your presentation. Welcome, Mr. Chairman.

SUMMARY STATEMENT OF CHRISTOPHER COX

Mr. COX. Thank you very much, Chairman Durbin. I know that Ranking Member Brownback will perhaps be here soon. Senator

Allard. It is a pleasure to testify before you today. Thank you for giving me this opportunity to engage in some sharing of information about our budget request for fiscal 2008.

Before I begin, I would like to congratulate you, Mr. Chairman, on assuming this new role. I am very, very pleased and looking forward to working with you.

As you know, we are requesting $905.3 million for the SEC in 2008, and that represents an increase, as you noted, Mr. Chairman, over fiscal year 2007 that will allow the SEC to continue the important initiatives underway to protect and inform investors. These initiatives all have in common that they are aimed at benefiting the average retail customer, whose savings are dependent on healthy and well-functioning markets.

Since I became Chairman I have worked to reinvigorate the agency's focus on the ordinary investor. This is the SEC's traditional responsibility. Back in Joe Kennedy's day, our first SEC Chairman could marvel that 1 in 10 Americans owned stocks. Today one-half of Americans own securities, and the median income for shareholders is a very middle class $65,000.

When you then consider all the teachers, the Government employees, and the workers in other industries who have pensions, it becomes clear that nearly all taxpayers have a personal interest in fair and honest securities markets. In fact, when one considers the staggering growth in Americans' participation in the market, the enormity of the SEC's task becomes apparent. About 3,600 staff at the SEC are responsible for overseeing over 10,000 public companies, investment advisers that manage over $32 trillion in assets, nearly 1,000 fund complexes, 6,000 broker-dealers with 172,000 branches, and the $44 trillion worth of trading conducted each year on America's stock and options exchanges.

These daunting numbers make it clear that, even if the SEC budget were to double or to triple, the agency would have to carefully set priorities. That is exactly what we are doing in our proposed budget for fiscal 2008.

Our risk-based and flexible approach to our examination program is permitting us to focus the agency's energies on the particular marketplace practices that are most likely to be high risk and on the particular investment advisers and mutual funds that are most likely to be sources of trouble. It also provides the basis for the selection of targets for comprehensive exam sweeps on crosscutting issues that could present a significant threat to investors, and it drives the SEC's enforcement, rulemaking, and disclosure reviews as well. In each case, the objective is to apply the taxpayers' resources in ways that make the most significant positive contribution to investor protection.

If I may, Mr. Chairman, I would like to point out some of the major areas in which the SEC is currently focusing its energies. Our most important initiatives begin with our focus on fighting fraud against seniors. There are an estimated 75 million Americans who will turn 60 over the next 20 years, and they are going to live longer than any generation before them. As the baby boomers turn 60, that is 10,000 of them every day for the next 20 years, they will need to continue to actively manage their investments for higher

yield over their longer lifetimes. It was not that way with their parents.

Rather than switching into low-yield safe investments as their parents did, they are going to have to be active managers overseeing their returns to provide for a much longer lifetime. That is going to have enormous consequences for our capital markets.

Households today led by people over 40 already own 91 percent of America's net worth; and, as the baby boomers retire, very quickly the vast majority of our Nation's net worth will be in the hands of our Nation's seniors. So following the Willie Sutton principle, scam artists are going to swarm like locusts over this increasingly vulnerable group because that is where the money is.

Nearly every day, the SEC receives letters and phone calls from seniors and their caregivers who have been targeted by fraudsters. That is why the SEC has focused its energies in this area and why we have organized our fellow regulators and law enforcement officials at the first-ever national senior summit, here in Washington last July. This year's summit, the second annual, will integrate even more of our national resources, and it will take place in just a few months with our partners.

We have developed a strategy to attack the problem from all angles. It includes aggressive enforcement, targeted examinations, and, very importantly, investor education. Over the past year the SEC's Division of Enforcement has brought 26 enforcement actions specifically aimed at protecting elderly investors. Many of those were coordinated with State authorities.

For example, the Commission coordinated with law enforcement authorities in California to crack down on a $145 million Ponzi scheme that lured elderly victims, elderly would-be investors, into workshops with the promise of free food and then bilked them out of their retirement money by purporting to sell them safe guaranteed notes. In another case we filed an emergency action to halt an ongoing securities fraud that targeted individuals' retirement funds.

By focusing on free lunch seminars and dozens of other techniques that would-be fraudsters aim at seniors, the Federal Government is serving notice that there will be a special place in hell reserved for those who prey on the life savings of older Americans.

Another important focus for the Commission is a program I know that is of significant interest to you, Mr. Chairman, and that is the agency's Office of Global Security Risk. As you know, this office, which is located in the Division of Corporation Finance, is responsible for monitoring companies' disclosures regarding their contacts with countries that have been identified by the State Department as State sponsors of terrorism and for coordinating with other Federal Government agencies to ensure the sharing of information that is relevant to that assessment.

The office reviews Securities Act registration statements and Exchange Act filings whenever it appears that a company may have material contacts with countries that raise global security concerns, and it requires enhanced disclosure where appropriate.

In the past year, the office issued comments to approximately 212 companies. The office conducts reviews both independently and in concert with the rest of the division's disclosure review staff. In

reviewing companies' disclosures, the office draws upon a variety of data sources. It also coordinates with the Treasury's Office of Foreign Assets Control and Commerce's Bureau of Industry and Security.

I appreciate the leadership of this subcommittee in ensuring that investors have the relevant information that they need to make informed investment decisions regarding the foreign activities of companies that they own, and I am confident that the Office of Global Security Risk is well positioned to continue fulfilling these vitally important responsibilities.

Another priority for the Commission is ensuring that the money that is recovered in SEC settlements and court cases is distributed as quickly as possible to injured investors. The Sarbanes-Oxley Act in 2002 gave the SEC this new "fair funds" authority. Since then we have begun to develop a very considerable expertise in this area. When I became Chairman in 2005, the SEC had completed the process of disbursing funds to investors in only a few cases. Since then we have returned over $1.7 billion in penalties and disgorgements to injured investors in significant cases, including WorldCom, Global Analysts Research, New York Stock Exchange Specialists, Hartford, and Bristol-Myers-Squibb.

In addition, several large disbursements are pending and will be announced very shortly.

To completely fulfill the vision that Congress wrote into Sarbanes-Oxley, however, will require a sustained effort to train professionals in this area. That is why I have ordered the creation of a new office that will work full time to return these funds to investors. The efforts of this new office will be aided by a new information system called Phoenix, that will more accurately track, collect, and distribute the billions of dollars in penalties and disgorgements that flow from our enforcement work. The efficiency of a dedicated tracking system will remove what has been a major hindrance in our efforts to quickly distribute fair funds.

Another major initiative I want to bring to your attention holds great potential for investors. It is called interactive data. By using interactive data, we can give investors far more information in a far more useful form than anything they have ever gotten from the SEC before. In the very near future, investors will be able to easily search through and make sense of the mountains of financial data contained in current company disclosures.

We are going to convert the SEC's current online system, called EDGAR (electronic data gathering analysis and retrieval system), from what is really now just a vast electronic filing cabinet into something that is truly interactive, a tool that lets an investor, an analyst, anyone, manage all of that information in ways that are truly useful to them. With a few clicks of the mouse, investors will be able to find, for example, the mutual funds with the lowest expense ratios, the companies within a particular industry that have the highest net income, or the overall trend in their favorite company's earnings.

To take advantage of the capabilities of interactive data, the SEC is modernizing the entire EDGAR system; and, as part of this effort, the very new and different EDGAR will be renamed later in 2007. It came as a bit of a shock to viewers of the hit TV show "24"

when Edgar bit the dust and it may take a while for people to get used to the new, improved EDGAR with a new name, but the effort will be supremely worthwhile.

In all, the Commission is investing $54 million over several years to build the infrastructure to support widespread adoption of interactive data.

Finally, I want to discuss a significant new responsibility that the SEC is undertaking this year to oversee credit rating agencies. As you know, in 2006 the Congress gave the SEC this new responsibility and new authority to register and inspect the Nation's credit rating agencies, including industry giants Standard and Poor's, Moody's, Fitch Ratings, and A.M. Best, as well as several other large, medium, and smaller current and potential industry participants.

Because of congressional concern that the industry faces potential conflicts of interest, imposes barriers to entry for new rating agencies, and has failed to warn the market of such significant impending financial failures as Enron and WorldCom, even immediately before their collapse, the SEC is tasked with devoting significant manpower and resources to this area. Under the new law and the SEC's proposed implementing rules, credit rating agencies will be required to register with the Commission. In addition, they will be required to submit to periodic inspections to ensure that they are implementing policies to mitigate conflicts of interest, prevent leaks of material nonpublic information, and to refrain from coercive or unfair practices.

The SEC takes this new responsibility very seriously. We remain committed to finalizing the new rules before the statutory deadline, and we are assembling a team of staff to oversee the program and begin conducting inspections over the next several months.

So with that background, Mr. Chairman, that brings us to our requested budget increase for fiscal 2008. That level will permit us to continue our ongoing hiring to reach a level of approximately 3,600 full-time staff. This level of personnel strength, which as you know is 21 percent higher than in 2001, will permit the agency to vigorously pursue its mission and maintain strong regulatory, enforcement, examination, and disclosure review functions. It will also allow the SEC to continue our commitment to information technology.

In addition to the SEC's interactive data initiative, the SEC is deploying new systems to better manage enforcement and examination programs. We are using new techniques and new technology to help make our existing staff more productive. There is absolutely no question that these technology improvements will make the SEC more productive and give investors and taxpayers more value for the money.

Over the last 2 years, the SEC has made tremendous progress in improving its operations. This fiscal 2008 request will permit us to continue improving the agency's internal financial controls. The SEC has poured tremendous energy into this area since I have been Chairman. As you know, a few years before I joined the SEC, the agency began to publish audited financial statements. I am pleased to report that for the first time in its history the SEC last year received a clean opinion of its audited financial statements for

2006, with no material weaknesses in internal controls. That is vitally important, Mr. Chairman, because the SEC must set an example not only for other Federal agencies, but also for the many public companies whose financial statements and disclosures we review.

For this reason, we plan to continue upgrading the agency's financial system and to beef up security over our information security.

The largest single application of our requested budget increase will be to fund pay raises for SEC staff that will average between 5 percent and 6 percent next year. These healthy increases are in accordance with the SEC's pay parity authority and our collective bargaining agreement. I should point out, Mr. Chairman, the fact that cost-of-living adjustments, career ladder promotions, and merit pay increases that are essentially built into our system amount to between 5 and 6 percent each year. That is a challenge for the SEC and for this subcommittee because two-thirds of our budget is personnel; and, if two-thirds of our budget is growing each year automatically by as much as 6 percent, then the agency's total budget has to increase by 4 percent just to maintain personnel at a steady state from year to year.

The final and most important reason that the SEC needs the budget increase that we are requesting is to provide the tools that we need to address emerging risks in the Nation's capital markets, including not just known areas of concern, such as hedge fund insider trading, the safety and security of 401(k) plans, and fraud in the municipal securities market, but also threats to market integrity and investor confidence that have yet to emerge.

PREPARED STATEMENT

So I appreciate, Mr. Chairman, the opportunity to discuss with you the SEC appropriation for fiscal 2008. I look forward to working with the subcommittee on the best ways to meet the needs of our Nation's investors. I would be happy to take your questions.

Senator DURBIN. Thank you very much, Chairman Cox.

[The statement follows:]

PREPARED STATEMENT OF CHRISTOPHER COX

Chairman Durbin, Ranking Member Brownback, and Members of the Subcommittee: Thank you for the opportunity to testify today about the Securities and Exchange Commission's budget request for fiscal year 2008.

Before I begin, I would like to congratulate you, Mr. Chairman, on your new role as head of this subcommittee. I look forward to working with you and all the members of this subcommittee for the benefit of the nation's investors.

As you know, the President's budget requests $905.3 million for the SEC in 2008. I fully support this request for increased funding over fiscal year 2007, which will allow the SEC to continue the important initiatives underway to protect and assist the average investor.

These initiatives all have in common that they are aimed at benefiting the average retail customer whose savings are dependent on healthy, well-functioning markets. Since I became Chairman, I have worked to reinvigorate the agency's focus on the ordinary investor. This is the SEC's traditional responsibility. Back in Joseph Kennedy's day, our first SEC Chairman was amazed that "one person in every ten" owned stocks. But today, more than half of all households own securities, and the median income for shareholders is a very middle-class $65,000. When you then consider all of the teachers, government employees, and workers in other industries who have pensions, it becomes clear that nearly all taxpayers have a personal interest in fair and honest securities markets.

In fact, when one considers the staggering growth in Americans' participation in the markets, the enormity of the SEC's task becomes apparent. About 3,600 staff at the SEC are responsible for overseeing more than 10,000 publicly traded companies, investment advisers that manage more than $32 trillion in assets, nearly 1,000 fund complexes, 6,000 broker-dealers with 172,000 branches, and the $44 trillion worth of trading conducted each year on America's stock and options exchanges.

These daunting numbers make it clear that, even if the SEC budget were to double or triple, the agency would have to carefully set priorities. That is exactly what we are doing in this proposed budget for fiscal year 2008. We must continue to think strategically about which areas of the market pose the greatest risk, and which areas of potential improvement hold the greatest benefit for investors. And given the fast changing conditions in America's and the world's capital markets, we must remain agile and flexible enough to redirect our resources with little notice.

This risk-based and flexible approach guides the SEC's examination program as we focus the agency's energies on those practices in the marketplace, and those investment advisers and mutual funds, that are most likely to be high-risk. It also provides the basis for the selection of targets for comprehensive examination sweeps on cross-cutting issues that could present a significant threat to investors. And it drives the SEC's enforcement, rulemaking, and disclosure review functions as well. In each case, the objective is to apply the taxpayer's resources in ways that provide the biggest investor protection bang for the buck.

In recent years, the SEC has professionalized the culture of risk assessment that informs so many of our programs throughout the SEC. From relatively modest beginnings as a discrete office within the SEC established by my predecessor, William Donaldson, the risk assessment function is now wholeheartedly embraced in every major functional division and office of the agency.

If I may, Mr. Chairman, I would now like to discuss some of the major areas in which the SEC is currently focusing its energies, in order to provide the maximum benefit to America's retail investors.

FIGHTING FRAUD AGAINST SENIORS

As you know, an estimated 75 million Americans will turn 60 over the next 20 years. And they will live longer than any generation before them. As the Baby Boomers turn 60—more than 10,000 of them every day for the next 20 years—they will need to continue to actively manage their investments for higher yield over their longer lifetimes, rather than switching into low-yield, safe investments as their parents did. This will have enormous consequences for our capital markets. Households led by people aged 40 or over already own 91 percent of America's net worth. The impending retirement of the baby boomers will mean that, very soon, the vast majority of our nation's net worth will be in the hands of our nation's seniors.

Following the Willie Sutton principle, scam artists will swarm like locusts over this increasingly vulnerable group—because that is where the money is. And it is already occurring. Nearly every day, our agency receives letters and phone calls from seniors and their caregivers who have been targeted by fraudsters.

That is why the SEC has focused its energies in this area, and why we organized our fellow regulators and law enforcement officials at the first-ever Seniors Summit in July 2006. This year's Seniors Summit, which will integrate even more of our national resources, will take place in just a few months. With our partners, the SEC has developed a strategy to attack the problem from all angles—from aggressive enforcement efforts, to targeted examinations, to investor education.

Fighting fraud against seniors means taking aggressive action. Over the past year, the SEC's Division of Enforcement has brought 26 enforcement actions aimed specifically at protecting elderly investors. Many of these were coordinated with state authorities.

For example, the Commission coordinated with law enforcement authorities in California to crack down on a $145 million Ponzi scheme that lured elderly victims to investor workshops with the promise of free food—and then bilked them out of their retirement money by purporting to sell them safe, guaranteed notes.

In another case, we filed an emergency action to halt an ongoing securities fraud that targeted individuals' retirement funds. At "free" dinner and retirement planning seminars, seniors were urged to invest their savings in non-existent businesses with promises of alluringly high rates of return.

By bringing cases like these, and dozens more like them, the federal government is putting would-be fraudsters on notice that they will be caught and punished if they prey upon seniors.

SEC examiners are also working closely with state regulators across the country to stop abusive practices before seniors are actually injured. With our state part-

ners, we're sharing regulatory intelligence about abusive sales tactics targeting seniors, and conducting focused examinations of any firms whose practices raise red flags.

For example, in Florida we initiated an examination sweep of firms selling investments to seniors, in cooperation with the State of Florida and the National Association of Securities Dealers. We subsequently expanded the sweep to include other states with large retiree populations—including California, Texas, North Carolina, Alabama, South Carolina, and Arizona. Working together with state securities regulators in those states, the NASD, and the NYSE, our goal is to see to it that the sales people at "free lunch" seminars are properly supervised by their firms, and that the seminars are not used as a vehicle to sell unsuitable investment products to seniors.

Another tool in fighting securities fraud against seniors is education. These efforts are aimed not only at seniors, but also their caregivers—as well as pre-retirement workers, who are encouraged to plan for contingencies in later life. The SEC is expanding our efforts to reach out to community organizations, and to enlist their help in educating Americans about investment fraud and abuse that is aimed at seniors. We have also devoted a portion of the SEC website specifically to senior citizens (http://www.sec.gov/investor/seniors.shtml). The site provides links to critical information on investments that are commonly marketed to seniors, and detailed warnings about common scam tactics.

GLOBAL SECURITY RISK

Another important area of focus for the Commission is a program of significant interest to you and other members of this subcommittee—the agency's Office of Global Security Risk. As you know, this office, which is located within the Division of Corporation Finance, is responsible for monitoring companies' disclosures regarding their contacts with countries that have been identified by the State Department as state sponsors of terrorism and coordinating with other federal government agencies to ensure the sharing of relevant information.

The Office reviews Securities Act registration statements and Exchange Act filings whenever it appears that a company may have material contacts with countries that raise global security concerns, and pursues enhanced disclosure where appropriate. In the past year, the Office issued comments to approximately 212 companies. The Office conducts reviews both independently and in concert with the rest of the Division's disclosure review staff.

In reviewing companies' disclosures, the Office draws upon a variety of data sources. The staff considers the information in a company's filings and information available from other sources. In addition, the Office continues to coordinate with other relevant federal agencies, such as Treasury's Office of Foreign Assets Control and Commerce's Bureau of Industry and Security.

I fully support the goals of this office and believe its efforts are increasing the quality of information that investors receive regarding companies' contacts with countries identified by our government as state sponsors of terrorism. I appreciate the leadership of this subcommittee in endeavoring to ensure that investors have the relevant information they need to make informed investment decisions regarding the foreign activities of the companies that they own. And I am confident that the Office of Global Security Risk is well positioned to continue fulfilling these vitally important responsibilities.

RETURNING FUNDS TO WRONGED INVESTORS

We at the SEC work diligently to uncover fraud against investors, gather the evidence needed to build a case, and then prosecute cases to bring fraudsters to justice. But our efforts do not end at the courthouse door. Once we succeed in convincing a court to order a penalty, we must ensure that as many of those dollars as possible go back into the hands of wronged investors as quickly as possible.

Since the Sarbanes-Oxley Act created "Fair Funds," through which penalties in SEC cases can be returned directly to injured investors, the SEC has begun to develop a considerable expertise in using this important new authority. At the time I became Chairman in 2005, this authority was only three years old, and the SEC had completed the process of disbursing funds to investors in only a few cases. Since then, we have returned over $1.7 billion to injured investors, including significant distributions from cases involving WorldCom, Global Analysts Research, New York Stock Exchange Specialists, Hartford, and Bristol-Myers Squibb. In addition, several large disbursements are pending and will be announced shortly.

To completely fulfill the vision that Congress wrote into Sarbanes-Oxley, however, will require a sustained effort within the Commission to train professionals in this

area, to develop consistent practices, and to routinize the execution of the Fair Funds function. Too much money is still undisbursed because of the complexities of the process, leaving investors uncompensated.

That is why I have ordered the creation of a new office that will focus the efforts of all of the SEC's offices around the country, and work full-time to return these funds to wronged investors. The creation of this specialized function within the SEC will ensure that investors' money is returned as quickly as possible, while minimizing the costs of the distributions.

The efforts of this new office will be aided by a new information system, called Phoenix. The system will more accurately track, collect, and distribute the billions of dollars in penalties and disgorgements that flow from our enforcement work. The efficiency of a dedicated tracking system will remove what had been a major hindrance in our efforts to quickly distribute Fair Funds.

The agency is taking other steps in this area as well. We are collaborating with the Bureau of the Public Debt to invest disgorgement and penalty funds in interest-bearing accounts. And we are working to consolidate funds from related cases into a single distribution, where appropriate, to potentially save investors hundreds of thousands of dollars.

The SEC is dedicated to doing the very best job possible for investors in handling this responsibility. We know that you in the Congress, who entrusted us with this task, expect and deserve no less.

INTERACTIVE DATA

Another major initiative I want to bring to your attention holds great potential for investors. By using what I call "interactive data," we can give investors far more information, in far more useful form, than anything they've ever gotten from the SEC before. In the very near future, investors will be able to easily search through and make sense of the mountains of financial data contained in current company disclosures.

For years, ordinary investors have been stymied by the time and effort it takes to separately look up each SEC filing for a single company they might own, and then to do that again and again for every additional company in which they're interested. Even once the right forms are located, wading through all of the legal gobbledygook to find the right numbers has been nearly impossible for the average retail investor.

That is because the SEC's online system, know as EDGAR, is really just a vast electronic filing cabinet. It can bring up electronic copies of millions of pieces of paper on your computer screen, but it doesn't allow you to manage all of that information in ways that investors commonly need.

Not surprisingly, financial firms—who can afford it—usually end up getting the bulk of their information about companies not from the SEC filings, but from middlemen all over the world who re-key the information in SEC reports and put it in more useful form. This process is expensive and inefficient, and it also creates errors in the data. Worse, it feeds the notion that the rich and the highly sophisticated have a leg up in today's markets.

Interactive data will let any investor quickly focus on the disclosure they need. With a few clicks of the mouse, investors will be able to find, for example, the mutual funds with the lowest expense ratios, the companies within an industry that have the highest net income, or the overall trend in their favorite companies' earnings. It works by giving each piece of information a unique label, written in the eXtensible Business Reporting Language (XBRL) computer language.

The agency has taken a variety of steps to expand the use of interactive data. First, the Commission created a voluntary program for companies and mutual funds to submit disclosures using XBRL, and offered expedited reviews of disclosures if firms agree to share their experiences with the agency. More than 35 companies, including some of corporate America's biggest names, are already participating in this program.

Second, the SEC is working with outside groups to develop the standardized computer labels for different kinds of numbers that appear in financial statements. The collections of these labels for each industry—the so-called "taxonomies"—will be completed in 2007. With the taxonomies available to every SEC registrant, we will have in place the basic building blocks of the universal language that explains the components of every firm's financial statements.

Third, the agency is modernizing the entire EDGAR system to convert it to one based on interactive data. As part of this effort, the SEC expects to rename the EDGAR system in 2007.

In all, the Commission is investing $54 million over several years to build the infrastructure to support widespread adoption of interactive data. Companies have told us that the costs of implementing XBRL are minimal, while the benefits are substantial. In addition to providing far more useful information to investors, we believe the use of interactive data will be more efficient for companies' internal processes, for their registration and compliance reporting to the SEC, and for the SEC's own disclosure reviews for regulatory and enforcement purposes.

CREDIT RATING AGENCIES

Finally, I want to discuss a significant new responsibility that the SEC is undertaking this year to oversee credit rating agencies. This new role was given to the SEC by Congress last year.

As you know, in 2006 the Congress gave the SEC both the responsibility and the authority to register and inspect the nation's credit rating agencies, including industry giants Standard & Poor's, Moody's, Fitch Ratings, A.M. Best, as well as several other large, medium, and smaller current and potential industry participants. Because of congressional concern that the industry faces potential conflicts of interest, imposes barriers to entry for new rating agencies, and has failed to warn the market of such significant impending financial failures as Enron and WorldCom even immediately before their collapses, the SEC is tasked with devoting significant manpower and resources to this area.

Under the new law and the SEC's proposed implementing rules, credit rating agencies will be required to register with the Commission. In addition, they will be required to submit to periodic inspections to insure that they are implementing policies to mitigate conflicts of interest, prevent leaks of material non-public information, and refrain from unfair or coercive practices. The SEC takes this new responsibility very seriously. We remain committed to finalizing the new rules by the statutory deadline, and we will assemble a team of staff to oversee the program and begin conducting inspections over the next several months.

FISCAL 2008 REQUEST

With all of this as background, I'll take just a moment to provide some useful detail about the President's budget request for fiscal year 2008.

As you know, the request is for $905.3 million. That will permit the agency to maintain its staffing levels from 2007. This level personnel strength, which as you know is significantly higher than five years ago, will permit the agency to vigorously pursue its mission and maintain strong regulatory, enforcement, examination, and disclosure review programs.

This funding level will allow the SEC to continue its commitment to information technology, which has the potential both to reduce regulatory costs and to give investors vastly more useful information than what they receive today. In addition to the SEC's interactive data initiative, the SEC is deploying new systems to better manage enforcement and examination resources, to help us manage a higher level of enforcement activity at existing personnel and funding levels. There is absolutely no question that these technology improvements will make the SEC more productive, and give both investors and taxpayers better value for their money.

Over the last two years, the SEC has made tremendous progress in improving its operations. The fiscal 2008 request will permit us to continue improving the agency's internal financial controls. The agency has poured tremendous energy into this area during my tenure as Chairman. I am pleased to say that these efforts have generated success: under the leadership of a new Executive Director, the SEC received a clean opinion on its audited financial statements for 2006 and, for the first time, there were no material weaknesses in internal controls. This is vitally important, Mr. Chairman, because the SEC must set the example not only for other federal agencies, but for all public companies whose financial statements and disclosures we review. For this reason, the SEC will continue to upgrade its financial system, and to beef up security over its information systems.

The President's budget request also will fund pay raises for SEC staff, in accordance with the SEC's pay parity authority and our collective bargaining agreement. This is a significant fact. Including cost-of-living increases, career-ladder promotions, and merit pay increases, these raises amount to between five and six percent each year. Given that from a budgetary standpoint the increases are essentially automatic, and given further that payroll represents about two-thirds of our budget, the agency's total budget has to increase by over 3.5 percent just to maintain personnel at a steady state from year to year.

Finally, and most importantly, the level of funding in this budget request will give the SEC the tools we need to address new, emerging risks in the nation's capital

markets—including not only such known areas of concern as hedge fund insider trading, the safety and security of 401(k) plans, and the quality of disclosure to protect against fraud in the municipal securities market, but also those threats to market integrity and investor confidence that have yet to emerge.

CONCLUSION

Thank you for this opportunity to discuss the SEC appropriation for fiscal 2008. I look forward to working with you on the best ways to meet the needs of our nation's investors, and I would be happy to answer any questions you may have.

SIMPLIFYING INVESTMENT INFORMATION

Senator DURBIN. Let me ask you a few questions. Most Americans may come in contact with your agency when they receive quarterly reports on their mutual funds or stocks that they own, and I assume that the contents of those reports are monitored, regulated by the Securities and Exchange Commission. Is that correct?

Mr. COX. That is correct.

Senator DURBIN. I would dare say as an attorney with little business background beyond law school that I find these overwhelmingly boring and unintelligible. Has anyone at the Securities and Exchange Commission taken a look at the required disclosures to try to follow the model that you suggested for EDGAR, to bring this down to a level where it might have some value to the average person, to require in simple, understandable terms some fundamentals about mutual funds that we own or stocks that we own, things that we should be aware of in the most direct way?

Mr. COX. Absolutely, Mr. Chairman. You are singing our song; we are singing your song. You sound like the average American customer that the SEC is supposed to be serving. When I have a chance to address large audiences, I often ask them: When you get your proxy information or your annual report in the mail, the SEC-mandated disclosure for the mutual fund or the stock or the security that you own, do you rush to your comfortable chair and sit down, open it up and read it? Nobody raises their hand and says yes to that.

I ask: How many of you—tell the truth—throw it away? And the whole room will raise their hand. I think the SEC has to be very concerned when the customers are throwing away the product.

The whole point of this exercise is meant to serve ordinary investors. Now, we recognize that what is being described is complex, and sometimes there is some required complexity in fully disclosing what is going on. But there is also a lot of complexity that is getting in the way, that is making it hard for investors to understand this information. Increasingly, I think, as we move to web-based tools, we are going to find that we can layer this information so that there can be some clearly understandable information on top; and then, if you want to keep drilling down for hyper-technical detail, you can find it. That I think holds great promise.

But, meanwhile, we are focused on plain English in all of the retail disclosures for which the SEC is responsible. We have a ways to go there, Mr. Chairman. I recognize that. But it is a top priority for the Commission in everything that we do.

Senator DURBIN. So let me ask you, do we have to change the law so that we can receive reports that are intelligible and of practical value to investors? Is it congressional responsibility or do you

have the power at the SEC to say that these things that you are mailing to millions of investors all over America, should at least have in the first four or five pages in very plain English important information that they should know about the company that is involved in it?

Mr. COX. We definitely have the power to do this. We are doing it now very formally in rule. The executive compensation disclosure that investors are receiving for the first time this year, much more detailed information about what the boss makes than they have ever had before, must be by rule in plain English, and we are going to review these disclosures with that in mind.

Senator DURBIN. Good.

PRIVATIZING SALLIE MAE

Now let me ask you about the proposed sale of Sallie Mae. This proposal suggests that it may be purchased largely by private entities, except for two banks. Chase and Bank of America, I believe, are involved in the proposed purchase of Sallie Mae. From the viewpoint of the public and especially students and their families, the current disclosures by Sallie Mae through SEC and other Federal agencies gives us an insight into how this agency is operating.

Should we have concern that if this private sale goes forward there will be less information available about how the new entity is operating, how student loans are being handled, the compensation of officers, how it is being spent? What kind of disclosure level do you think there would be in this new entity that is proposing to buy Sallie Mae?

Mr. COX. Well, it is an excellent question. Obviously the Congress has a special interest and the public has a special interest in GSE disclosure. There has been voluntary disclosure that is meant to conform with the SEC requirements that apply to all public companies. There is nothing that would prevent that under any private ownership.

Senator DURBIN. But would it have to be voluntary? This is what I am getting to. When I have raised this question with one of the banks involved in the proposed sale they said: Well, we have so many things we are already disclosing; there will be more disclosure than you know what to do with. So I was trying to get to the bottom line. Current disclosure standards for a public corporation like Sallie Mae I would assume are at this level [indicating], and now that we have a private entity buying this public entity will the disclosures at least reach this level [indicating] of information and transparency?

Is this something that maybe I could ask your staff to take a look at and give us some feedback?

Mr. COX. We are, as you can imagine, keenly interested ourselves, and I would be happy to continue to work with you on this.

Senator DURBIN. Good.

SUDAN DIVESTMENT

Before I turn it over to my colleague here for a few questions, let me ask you about the situation in Sudan. I contacted you earlier this year about the divestment interest which I have in order to put pressure on the Sudanese government to finally respond to the

genocide in Darfur, which has been acknowledged by this administration. After receiving some information from your Commission—there was a list of some 16 companies—it turns out that that is only a fraction of the actual activity that goes on in Sudan.

When we asked your staff why we did not have more information, we were told that the SEC can only compile such a list based on available information and such a list is obsolete almost as soon as it is created since companies shift operations continuously. So we are now working with Treasury and the State Department to create stronger reporting requirements to the SEC so that better information is available.

Before I ask you the specific question, I would like to add a footnote to that. There has been a great deal said recently by myself and others about Fidelity, a major brokerage company which it has been alleged has large holdings in PetroChina, the largest oil company in Sudan. You may have seen some ads on television and in publications. We were informed today it has been announced that Fidelity has sold at least 30 percent of the $1.1 billion in Hong Kong-listed PetroChina shares held as of December last year. We are still looking into it to determine how much they have divested.

But going back to my earlier point, if we are looking for companies like Fidelity and others doing business in Sudan, what do you recommend that we do to ensure the SEC can collect the kind of data that makes our effort more likely to succeed?

Mr. COX. As you know, Mr. Chairman, your efforts, which we have been assisting, I think are properly aimed at a universe that is larger than just U.S.-listed companies, and the PetroChina example that you gave—PetroChina did not appear on the list that we provided of our registrants for the simple reason that it was not a U.S.-listed company. That is, the subsidiary listed in the United States did not have material contacts in Sudan and the parent, PetroChina, is not a U.S.-listed company. Because of the U.S. sanctions regime, not very many listed U.S. companies are the entities that themselves have the material contacts.

So I think, if we are after the information that you seek, we need to broaden our horizons a little bit. Although the SEC can be very helpful in this regard, and I know that you are also working with the Treasury Department and the State Department, I think a multiagency effort is the best way to go.

Senator DURBIN. Well, I hope we can find that information, because I think at a minimum if Americans who are concerned about the issue are alerted to those companies that are doing business in Sudan and have a choice as consumers and investors to act accordingly that is the best we can do at this moment in time. We need to have a more robust effort to bring this information together and I will work with you to achieve that.

I see Senator Brownback has arrived. I do not know if you would like to ask or let Senator Allard.

Senator BROWNBACK. Let Senator Allard.

Senator DURBIN. Senator Allard is recognized for 5 minutes.

NASD–NYSE CONSOLIDATION

Senator ALLARD. Thank you, Mr. Chairman. I mentioned in my opening comments about the consolidation of the National Associa-

tion of Security Dealers and the New York Stock Exchange regulatory function. The question I have for you, Chairman Cox, it is my understanding that the Division of Market Regulation is going to be responsible for regulation and supervision of the proposed consolidation. Do you feel that the SEC's budget request provides enough for these challenges and other initiatives that will modernize the national market system?

Mr. COX. I do. In fact, I think in some ways the consolidation of the regulatory functions of the NASD and the NYSE will make it easier to track fraud across markets. We had a problem heretofore with the sheriff having to stop at the county line. Fraud does not neatly restrict itself these days to one particular platform, one particular market, and, to the extent we have a more crosscutting view of what is going on in our market surveillance, we will be much more efficient at tracking down fraud.

PROGRAM ASSESSMENT RATINGS

Senator ALLARD. As you will recall when we were in the House, the Contract with America, we worked with the Government Performance and Results Act (GPRA) and the way that became law and the way the Government agencies now is implementing it is the President's PART program. I am developing a reputation that on these Appropriations subcommittees I always ask whoever is testifying about how well their agency is doing in the PART program.

I look here and I pulled the information off of the Internet on Expectmore.gov, and I see where the Securities and Exchange Commission, you have four programs that they refer to. The regulation of the investment management industry is listed as effective, and I congratulate you on that. The examining and compliance with security laws, that is characterized as moderately effective. Then there is a couple of agencies, what we call the Securities and Exchange Commission enforcement and then the Securities and Exchange Commission full disclosure program, that it says results not demonstrated, which tells me that they are not bothering to set objectives and try and move toward those.

Now, I noticed in your comments that you referred to these programs and that some of the money you are requesting is to upgrade those programs. So my question is how are you coming along on getting more accountability in those two particular programs, where results are not demonstrated?

Mr. COX. First, thank you for asking about this, because it is something that we are very focused on from a management standpoint at the SEC. You are right to point out that the 2007 PART review that focused on the Division of Investment Management gave the SEC the highest rating. As you know, that rating of "effective" is very rarely awarded. It is hard to get, and so that was cause for I think well-deserved celebration at the agency. We are very proud of having achieved that in 2007.

Likewise, the Office of Compliance, Inspections, and Examinations received the next to the highest rating last year. Prior to the time that I came to the Securities and Exchange Commission, these other reviews that you mentioned were performed. The Enforcement Division, results not demonstrated, and the Division of Cor-

poration Finance likewise, are for that reason very much in our focus. We are working right now with the Government Accountability Office (GAO), which is performing another management review of the Division of Enforcement, and we hope that, as a result of that collaboration and also our own internal management assessment, we will be able to develop additional measurable performance ratings.

The enforcement area, as you can imagine, it is difficult. We are first and foremost a law enforcement agency, and it is the greater part of what we do. So we are very interested in anything that we can do to measure results.

One of the things that we observe in the economy right now is that there are fewer security class actions being filed now than there have been in prior periods. There are a number of potential explanations for that, and I think only social scientists can parse, perhaps only to their own satisfaction, what the causes are for this.

But looking for a measure of less fraud, which would be the ultimate performance that you would like our enforcement to achieve, is very difficult. So we are trying to come up with any way that we can measure this. We probably will not use such external measures for the reason that there is so much social science involved. But certainly we are going to develop even more rigorous measurements than we have used in the past so that we can satisfy ourselves that the taxpayers' resources are being put to the best use for the protection of investors.

Senator ALLARD. Well, thank you for your response. Next year when you show up I will probably repeat that question and see how well we are doing.

Now, has the GAO reviewed from the PART program perspective, have they reviewed all your programs, and if not how many more remain to be reviewed?

Mr. COX. Well, the GAO has on a number of occasions reviewed aspects of the SEC's operations. Their current ongoing study involves the Division of Enforcement.

Senator ALLARD. Okay. So are there more programs that need to be reviewed yet that are not listed on here, or is this pretty much it?

Mr. COX. Well, the PART program, as you know, picks a different portion of the agency each year.

Senator ALLARD. Right.

Mr. COX. And I do not know, frankly, where the Office of Management and Budget (OMB) will go next.

Senator ALLARD. Okay. Well, we will want to follow up on that one too.

Thank you for your testimony.

Mr. COX. Thank you.

Senator DURBIN. Senator Brownback.

Senator BROWNBACK. Thank you, Mr. Chairman.

Welcome, Chairman Cox. Good to see you again. I want to join the chairman in his comments on Sudanese divestiture. We have a strong, growing campaign across the country. I am not sure where we are on the number of States. I do know Kansas just divested. We have probably between 8 to 10 States now that are involved in public divestiture from Sudan. I would hope you could

help us out with that. It seems to me that is one of the best ways that a citizenry can express its displeasure with the genocide. You can say, you can conduct a genocide, we do not like it, and we are going to fight you every bit of the way, but it is certainly not going to be on our dime that you are going to do it. So your willingness to help is greatly appreciated.

DECLINE IN IPOS ON U.S. EXCHANGES

I want to target you in on two things that have been seen in some of the publications. One is the reduction in IPOs in our capital markets that have been the subject of a number of articles recently, the New York Times, Wall Street Journal, Financial Times, and Economist. There is a recent report from McKinsey and Company commissioned by Senator Schumer and New York City Mayor Bloomberg that found in the first 10 months of 2006 U.S. exchanges attracted barely one-third of the share of the IPOs they captured back in 2001. They noted at the same time European exchanges increased their market share by 30 percent, and Asian exchanges doubled their share.

The study found the trend was due to non-U.S. issuers' concern about compliance with Sarbanes-Oxley (SOx) section 404 and operating in what they see as a complex and unpredictable legal and regulatory environment.

I would ask you, as I am sure you have seen the same things, do you agree with these findings and what could be done to stem this flow of companies going to foreign exchanges?

Mr. COX. Well, Senator, I think the United States always needs to be focused on sharpening our competitive edge in every way that we can. The SEC has, of course, as our statutory mission protecting investors, but another statutory mission of the Securities and Exchange Commission is promoting capital formation, and we are focused on that, as we are focused on our third statutory mission, which is maintaining orderly markets. All of these things I think are complementary.

We have to be concerned, when we see that there is more competition in the world now than there ever has been before, to see that the United States of America has a regulatory system that is pro-competition, that is efficient, that achieves all the objectives of investor protection that we want, but that it also succeeds in our market regulatory objective and also our objective of——

Senator BROWNBACK. Do you think it is due to section 404 of Sarbanes-Oxley? Is that a key part of why we are losing competitiveness?

Mr. COX. We have heard from foreign private issuers who listed in the United States that they are very concerned about the operation of section 404. We have also heard that same complaint from U.S. issuers. Because of this, we have gone back to the drawing board. We are on the threshold—and it will occur on May 23 and May 24—of repealing in its entirety the audit standard that was issued shortly after the passage of Sarbanes-Oxley by the Public Company Accounting Oversight Board under SOx 404 and replacing it with one that has the benefit of the interim years of experience.

It is going to be top-down, risk-based, principles-based, materiality-focused, and scalable for companies of all sizes. None of those things was really a forte of the original standard.

Senator BROWNBACK. Do you think that will get at this loss of the flight of companies to foreign markets?

Mr. COX. That is certainly a part of it. But I started with a reference to competition for this reason. There is more competition now than there used to be. In days gone by there simply were not the large pools of capital around the world to tap, nor the technological means and the commercial means that would offer a feasible choice for many issuers.

Today that competition exists. I think the competition itself is good. It is healthy. It tends to reduce the cost of capital. But we want to make sure that that competition is not a regulatory competition that lowers standards for investor protection. So we are working with our counterpart regulators to make sure that, as we flense the blubber from the regulatory system and wash out any unnecessary costs, we, if anything, increase the level of investor protection by closer collaboration overseas.

If you take a look at what is actually going on in the markets, while it is true that the lion's share of foreign IPOs went elsewhere and we did not attract them in the United States in recent years, this year we are on track, according to Thomson Financial, to add the most foreign listings on U.S. exchanges since 1997. That is a good development.

It was also recently reported that foreign companies accounted for over 23 percent of IPO proceeds last year, and that is the highest since 1994. So there is every reason to think that the United States will maintain its lead and the largest market share on Earth. We are still the largest, deepest, most liquid pool of capital in the world. But we do not want to take that for granted, and regulators as well as marketplace participants all have to constantly sharpen our competitive edge.

Senator BROWNBACK. I appreciate you looking at that and considering that. I am putting in a bill today on the Communities First Act, that is to provide targeted regulatory relief for community banks—these are small banks across the United States—that will provide some relief on section 102 of Sarbanes-Oxley by exempting insured depository institutions with consolidated assets of $1 billion or less from provisions of the internal control requirements in section 404.

I just advise you of that. In my State we have a number of small banks, small institutions. A number of the Sarbanes-Oxley provisions have been very difficult, very onerous on them, and this regulatory relief would be something that would be helpful. I want to make sure that this regulation is not putting the United States at a competitive disadvantage in global capital markets.

I appreciate your answer and working with us on these topics. Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Brownback.

RIGHTS AND REMEDIES AVAILABLE TO INVESTORS

A few more questions if I might. It is my understanding, Chairman Cox, based on the Wall Street Journal article of April 16 that

the SEC is exploring the idea of eliminating the rights of investors to pursue legal remedies in court, instead shifting to arbitration. Inasmuch as your responsibility as Chairman of the SEC includes protecting investors and maintaining fair, orderly, and efficient markets, I would like to ask you a few questions if I might.

You stated earlier there are fewer class actions that are being filed, which is an indication that the litigation rate is not increasing. But when it comes to this suggestion of moving the rights of investors to arbitration as opposed to the court system and this limitation of the legal rights of investors, how would you rationalize that decision against the fact that most of the arbitration hearings are going to be private in nature and some of the most dramatic information we have received about corporate wrongdoing, such as the *Enron* case, came in public forums, before the courts, leading to congressional response and perhaps a little more wariness on the part of investors?

Are you not going to sacrifice some of that openness and transparency in this process if you move to an arbitration standard?

Mr. COX. Well, Mr. Chairman, I appreciate the opportunity to state very clearly, as I did to the reporter who wrote the story that you mentioned, that there is no pending rule or proposal before the Securities and Exchange Commission to allow corporations to mandate arbitration of shareholder claims. The source for the story is unclear. It was not explained to me by the reporter. But, as you will note, there were no other such stories, and I hope that I can speak authoritatively to that subject.

Senator DURBIN. Thank you.

EXPEDITING FAIR FUND DISBURSEMENTS

Let me ask you, you have addressed this earlier, but I want to make sure it is clear in the record here. The fair funds for investors provision in Sarbanes-Oxley requires the SEC to return money to investors victimized by securities fraud. I think that your earlier statement was that you were making a more concentrated effort in trying to return these funds. The Government Accountability Office determined that as of 2005 the SEC had disbursed money to wronged investors in only a few cases—that is in 2005—and criticized the SEC for its slow process for disbursing more than $4.8 billion in disgorgement and penalties it had collected during the previous 3 years. While the SEC had used the fair funds provision in 75 cases, collecting money in a majority of those cases, the investors in only 3 of those cases had received any money.

You quoted an earlier figure which I believe was $1.8 billion. I may be wrong.

Mr. COX. $1.7 billion.

Senator DURBIN. $1.7 billion.

Could you tell me, what is the status of this fair funds activity and whether that represents—it does not represent one-half, I believe, of what the GAO reported. But does it represent or is it an indication that this next year there will be even more funds to be disbursed?

Mr. COX. It is in fact, Mr. Chairman. The figures that you mentioned and the report that you mentioned from 2005, of course, represented the state of affairs that I found at the agency when I be-

came Chairman in August 2005. That is why I made it an immediate priority. The $1.7 billion that we have distributed as of now is a substantial increase over what was the case in 2005.

There is also $3.4 billion that we are very soon going to be able to distribute that relates to the recent mutual funds scandals, and that will be then the lion's share of the $3.8 billion remaining backlog.

Senator DURBIN. Let me ask you about the WorldCom matter. The SEC collected $750 million in penalties and fines there. Could you tell me, what is the status of that reimbursement? I understand some $150 million should be doled out to investors.

Mr. COX. We have recently distributed $500 million, beginning this past October. There is, however, more to be distributed. The $750 million in total fair fund that was established and approved by the court in July 2004 was subsequently appealed to the Second Circuit Court of Appeals, and they then approved the lower court's decision in October 2006.

WorldCom also recently emerged from bankruptcy and there was a 9-month claims period because WorldCom was one of the most heavily traded stocks in the market and was widely held by small investors. The former Chairman of the Securities and Exchange Commission, Richard Breeden, is serving as our distribution consultant in this matter, and he has submitted a distribution plan that we started executing immediately after they emerged from bankruptcy.

VOLUME OF DISCLOSURE REVIEWS

Senator DURBIN. Mr. Chairman, your budget submission projects that the Divisions of Corporate Finance and Investment Management expect to review the disclosures of about 33 percent of all reporting companies and investment company portfolios. In last year's request you indicated that 44 percent of the disclosures would be reviewed. First, how do you select the disclosures to be reviewed? What is the total volume of filings, and why would you propose in next year's budget a 25-percent decrease in the number of disclosure reviews?

Mr. COX. The basis for the selection of submissions to review is risk. That is true not only in the Division of Corporation Finance, but it is true in our Office of Compliance, Inspections, Examinations, and the Division of Enforcement.

SOx requires now that we review all the registrants once every 3 years, and so we are embarking upon that approach separately. The volume of filings as against the risk of filings gives us a tradeoff, therefore, that we have to make, because SOx is just purely quantitative. We have got to get to all of them ultimately. On a risk-based approach, we can focus our resources where they are better used.

The figures that we provided to you about the number that we expect to reach are projections; and we do not know precisely where we will end up, of course, until we have the experience.

Senator DURBIN. Why would the percentage of those reviewed decline by 25 percent from this fiscal year to next fiscal year?

Mr. COX. That is simply an estimate based on meeting our SOx obligations at the same time that we pursue a risk-based approach to reviewing the filings.

SCHEME LIABILITY LITIGATION

Senator DURBIN. Let me ask you about the issue of scheme liability litigation. The SEC has in the past taken the position in amicus curiae filings that someone who engages in deceptive conduct may be liable for engaging in a scheme to defraud even without making false statements directly to the public if the person undertook acts with the purpose and effect of creating a misleading impression. For example, in October 21, 2004, the SEC filed a brief in the *Home Store* case in the Ninth Circuit saying that if a third party engages with an issuer of securities, "in a transaction whose principal purpose and effect is to create a false appearance of revenues intending to deceive investors in the corporation's stocks, it may be a primary violator."

The Ninth Circuit relied on the SEC's interpretation in its ruling and said: "We agree with the SEC that engaging in a transaction the principal purpose and effect of which is to create the false appearance of fact constitutes a deceptive act."

Has anything occurred, Mr. Chairman, in the past 3 years that would cause the SEC to change its position on the liability of third parties?

Mr. COX. No.

Senator DURBIN. The issue of scheme liability is going to be before the Supreme Court next term in the *Stoneridge* case. This is also an issue that is at the heart of the decision by the Fifth Circuit effectively denying the Enron victims their day in court against the investment banks allegedly involved in the fraud. The SEC has an opportunity to file an amicus brief on June 11 standing up for its own rule and for the integrity of the financial markets, as it did in the *Home Store* case. Can investors count on the commission's support?

Mr. COX. As you know, Mr. Chairman, the Solicitor General will file a brief on behalf of the United States. The SEC will, I believe, soon receive a recommendation from our General Counsel on precisely how to proceed in that particular case. The Commission will vote on it, and then we will make our recommendations to the Solicitor General.

I expect that the net result of all of that will be that the United States Government will do its level best to make sure that injured Enron investors receive the full amount of recovery to which they are entitled in our legal system.

Senator DURBIN. So this matter has not been decided? It will be under consideration after the Solicitor General——

Mr. COX. Yes, this is all relatively recent in the last few weeks.

STUDENT LOAN REPAYMENT FOR SECURITIES AND EXCHANGE COMMISSION EMPLOYEES

Senator DURBIN. I would like to ask you one last question. Do you use student loan forgiveness to recruit and retain professional personnel?

Mr. COX. It is an excellent question. I do not know the answer. Let me see. Yes. Our Executive Director, sitting right behind me, tells me that we do.

Senator DURBIN. The staff just handed me a long list of people who have benefited from this. So it appears that you do use it. In fact, I would like to congratulate you for being a Federal Government leader in using this program. It turns out 365 employees receive some money in student loan repayment benefits. This is a program which I have encouraged. I think it is an excellent way of attracting the best and the brightest to public service when they are burdened with student debt and might consider other careers. So I hope that you will continue to use that.

Mr. COX. We certainly will take your enthusiasm as it is intended.

Senator DURBIN. Thank you very much, Mr. Chairman, for testifying today. I thank all those who have come from the Securities and Exchange Commission.

ADDITIONAL COMMITTEE QUESTIONS

Our record will remain open for 10 days if there are any written questions to be sent to you from our staff or the staffs of the other Senators involved.

[The following questions were not asked at the hearing, but were submitted to the Commission for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR RICHARD J. DURBIN

ARBITRATION

Question. In response to an inquiry at the hearing, you mentioned that a report in The Wall Street Journal that the Commission is considering a proposal originally described in the Capital Markets Study that would empower corporations to amend their bylaws to mandate arbitration of securities fraud class action cases was "inaccurate" although you did not specify how the article was inaccurate. What assurance can you provide the Subcommittee that the SEC is not considering any changes regarding arbitration?

Answer. There is no pending rule or proposal before the Commission to allow corporations to mandate arbitration of shareholder claims. Corporations should not be able unilaterally to limit the rights of investors to sue, and I can assure you that the Commission does not plan to advance any proposal that diminishes investor rights.

MARKET COMPETITIVENESS

Question. Three recently issued reports—the Committee on Capital Markets Regulation Report, the McKinsey Report, and a report from the U.S. Chamber of Commerce—raise concerns about the competitiveness of the U.S. capital markets. These reports concluded that the competitiveness of the U.S. markets is being hampered by our overzealous regulatory and litigation environment.

All three reports relied on the same fact to support their claim—that the U.S. share of the global IPO market dropped between 2000 and 2006. This statistic, however, is highly misleading. In fact, since the implementation of the Sarbanes-Oxley Act, the number of U.S. IPOs has risen dramatically. According to a recent article in Barron's, IPOs in 2006 increased 22 percent over 2005, and 170 percent over 2003. During that same period, the number of foreign companies listing in U.S. markets and the amount of money they raised here have also increased.

Furthermore, a recent study by Craig Doidge of the University of Toronto and Andrew Karolyi and Rene Stulz of Ohio State University found that there remains a significant premium for companies that list in the United States, and this premium has not declined in recent years, despite recent regulatory developments. The pro-

fessors also found that an exchange listing in New York still continues to provide significant benefits to firms.

These facts confirm that U.S. markets are among the most highly competitive in the world, and suggest that we are so competitive precisely because of the unmatched protections we provide to our investors.

What is your opinion? Do you believe that a market that provides such protection and transparency actually increases competitiveness?

Answer. Yes. I agree. U.S. markets thrive because of the global trust we've earned. That makes the SEC itself a key part of America's capital markets that helps secure our global leadership, maintain our markets' competitive edge, and secure the benefits of robust capital formation for millions of Americans as well as countless people the world over. But the SEC can only continue in this role if we constantly update our rules, our policies, and our own way of operating to keep pace with the increasingly rapid changes in the world of finance that we regulate. The new global competition is good in that it tends to reduce the cost of capital. But we are working to make sure that that competition is not a regulatory competition that lowers standards for investor protection and ultimately undercuts America's role as the leading capital market in the world.

INVESTOR FRAUD TARGETING SENIORS

Question. Chairman Cox, in your prepared statement you discuss the SEC's initiatives to combat investor fraud schemes which particularly target seniors. I understand that the SEC recently teamed with the University of Illinois College of Law and the Federal Reserve Bank of Chicago to host a symposium focusing on this issue in Chicago.

Are there certain schemes that are aimed at older Americans?

What recommendations do you have for older Americans to better guard their retirement funds? What is the SEC doing to inform and educate consumers?

What specific actions has the SEC taken to reduce the prevalence of these unscrupulous practices? What remedies have been the most effective?

Answer. It was a great pleasure to be in Chicago on May 18 for the Senior Symposium the Commission hosted with the Elder Law Journal of the University of Illinois College of Law and the Federal Reserve Bank of Chicago. The Symposium featured a distinguished panel of representatives from the business, law, regulatory and academic communities with significant experience tackling the issues facing seniors as they prepare for and enjoy their retirement. The panelists discussed how older Americans can protect themselves from investment fraud while financially preparing for the future. It was a very instructive and successful event.

As you know, fighting fraud against seniors requires aggressive action. That's why last year I launched the SEC's "Seniors Initiative," which is designed to better coordinate the work of the SEC's various offices and divisions and with state securities regulators when it comes to prosecuting and preventing securities fraud aimed at swindling senior citizens.

Educational efforts are an important of the Commission's strategy for seniors and we are dedicated to putting better information in their hands so they can make informed investment decisions. We are conducting a series of seniors events around the country and will hold the second Senior's Summit this fall.

We know that many seniors, and many children and caregivers of seniors, use the Internet to search for information on investing. That is why we created a section on our website (http://www.sec.gov/investor/seniors.shtml) aimed specifically at senior investors.

The information on this website can help seniors fend off high pressure sales pitches for legitimate, but arguably unsuitable products. After reading our materials on equity-indexed annuities, for example, seniors will know to avoid any salesperson claiming that individuals "can't lose money" in that product. Investors can lose money buying an equity-indexed annuity, especially if the investor needs to cancel the annuity early.

In addition to providing critical information on other investments commonly marketed to seniors, such as variable annuities, promissory notes, and certificates of deposit, the website also provides key information about how to detect and avoid fraudulent schemes.

This is also a top enforcement priority for the SEC. Since many of the scams targeted at seniors involve ongoing fraud or Ponzi schemes, time is often of the essence—both to stop the ongoing fraud and to recover lost investor funds. In these instances, the staff may move very quickly and seek emergency relief in the district courts. Once emergency relief is obtained and the status quo is preserved to the extent possible, the Enforcement staff generally goes through the same detailed proc-

ess it would in any investigation, which include interviewing witnesses, requesting and reviewing documents, and taking formal testimony.

The existing statutory penalties provide a broad range of available sanctions, including cease-and-desist orders, censures, injunctive relief, disgorgement, civil penalties, and industry bars. Moreover, civil monetary penalties may be imposed in cases involving repeat violations and severe frauds. I believe that the Commission's full range of existing remedies allows enough flexibility to ensure that the Commission can effectively prosecute cases involving fraud against seniors. This is particularly true given the SEC's ability to make criminal referrals in the most egregious cases.

STOCK OPTION BACKDATING AND SPRINGLOADING

Question. Numerous media accounts in recent months have reported that many companies may have bent our securities laws by engaging in stock option backdating and springloading as a way to provide senior corporate management with manufactured gains.

Do you view the proliferation of this practice as a serious threat to the integrity of the securities laws which you oversee?

If so, how many cases has the SEC brought in this area in the last year?

Does the SEC need greater enforcement resources to combat compensation practices such as these?

Answer. The SEC's Division of Enforcement is currently investigating more than 140 companies for possible fraudulent reporting of stock option grants. The companies under investigation are located across the country, are of various sizes, and span multiple industry sectors. All of the SEC's regional offices are currently involved in these investigations.

Longstanding SEC policy precludes the disclosure of any information about these ongoing investigations; however, enforcement actions have been filed against former executives of Symbol Technologies, Peregrine, Brocade, Comverse Technology, McAfee, Monster Worldwide, TakeTwo Interactive Software, Engineered Support Systems, Apple Inc. and Mercury Interactive. To date, the Commission has brought enforcement cases against 4 issuers and 19 former executives. These cases involved alleged misconduct of chief executive officers, general counsels, chief financial officers, and other accounting and human resources employees. The Department of Justice has also brought parallel criminal actions against 10 of the 18 former executives charged by the Commission.

The SEC has taken many steps to ensure clear, full, and fair disclosure about executive compensation, including that relating to employee stock options. The revised executive compensation disclosure rules the Commission adopted in July 2006 include a number of provisions that directly or indirectly address backdating of options. For example:

—A company must now disclose how it determines when it will make equity awards. This will require a company to disclose how, and why, it backdates for its executives.

—A company must disclose the grant date of equity awards. If the grant date is different than the date on which the board took action, the company must disclose the date of the board's action.

—A company must disclose the exercise or base price of an option if it is less than the market price of the underlying security on the grant date. If it is less than the market price on the grant date, the company must disclose the market price on the grant date. This disclosure is intended to provide an investor with a complete picture of the true terms of each option award by allowing the investor to compare the grant date market price to the in-the-money exercise price.

—Further, if the exercise or base price of an option grant is not the closing market price per share on the grant date, a company must describe its methodology for determining the exercise or base price.

In addition, the Sarbanes-Oxley Act of 2002 tightened up a company's obligation to report stock option grants. Before Sarbanes-Oxley, officers and directors were not required to disclose their receipt of stock option grants until after the end of the fiscal year in which the transaction took place—which meant that an individual, in some cases, had more than a year to disclose a grant. In August 2002, the SEC issued rules requiring officers and directors to disclose option grants within two business days.

In combination, these steps are an important contribution to preventing backdating abuse. They have effectively eliminated easy opportunities for companies to secretly grant options. Companies are beginning to file reports with disclosure of executive stock option grants in accordance with the Commission's new rules. Staff

from the Commission's Division of Corporation Finance will selectively review these reports for compliance with the new rules, including those relating to stock option awards. Where the disclosures indicate possible violations of the federal securities laws, appropriate referral of the matter will be made to our Division of Enforcement.

COMMISSION APPROVAL FOR SETTLEMENT TALKS

Question. On April 13, 2007, the Washington Post reported that SEC had made a change in procedures such that your enforcement lawyers must seek approval from the Commission before they begin settlement talks that involve fining corporations, including seeking ranges for possible fines. It has also been reported that this action may lead to lower penalties.

Please comment on whether this report is accurate and whether you believe it will lead to lower penalties and if so, was that its intent?

Answer. The Commission's procedures for authorizing settlement negotiations in cooperate penalties cases are not designed to increase or decrease the amount of monetary penalties paid by companies or to make penalty payments more or less frequent. Rather, they are intended to strengthen the negotiating position of our Enforcement Division in settlement negotiations involving corporate penalties and streamline the approval process for those cases. The implementation of the procedures will be carefully monitored, and the procedures will not be continued if they do not achieve these key objectives.

The process is designed to ensure that the laws are vigorously enforced by giving the professional enforcement staff the full backing of the Commission in the staff's settlement negotiations.

The pilot streamlines the settlement process by shortening final Commission review and approval when the staff reaches a settlement within the range authorized by the Commission.

The staff may always return to the Commission to recommend a higher or lower penalty range if their recommendation changes based on new information or a development that occurs during the settlement negotiations.

WEAKNESSES IN INFORMATION SECURITY CONTROLS

Question. In carrying out its mission to ensure that securities markets are fair, orderly, and efficiently maintained, the SEC relies extensively on computerized systems. Integrating effective information security controls into a layered control strategy is essential to ensure that SEC's financial and sensitive information is protected from inadvertent or deliberate misuse, disclosure, or destruction. In fact, one of SEC's four strategic goals is "maximizing the use of SEC resources," which expressly includes "enhancing internal controls."

A recent GAO study acknowledged that the SEC has made progress toward correcting previous weaknesses in information systems security, and attributed progress to active engagement by SEC senior management in implementing reforms. However, GAO emphasized that despite progress, the SEC has not consistently implemented key controls to effectively safeguard the confidentiality, integrity, and availability of its financial and sensitive information and systems.

GAO recommends that the SEC Chairman improve the implementation of its policies and procedures, control tests and evaluations, and remedial action plans as part of its agency-wide information security program.

Chairman Cox, what is the SEC actively doing to implement GAO's recommendations to correct information security control weaknesses?

Answer. The SEC now devotes about 7 percent of the agency's information technology budget on technology security—a significantly greater share of overall information technology resources than many other agencies. Our efforts run the gamut from highly technical initiatives such as server configuration management, to equally critical but "softer" programs such as user awareness training.

In one major improvement initiative, the SEC has invested over $2 million during fiscal year 2006 to enhance our core financial management system. These upgrades include new hardware and software, as well as implementing a more secure database. As part of this upgrade, the SEC will continue to make enhancements to business processes and automated workflows that will improve internal controls, eliminate traditional financial management paper processes, and enhance reporting capability and efficiency. Beyond these benefits, the updated hardware and software will provide much greater assurance that the system complies with modern information security standards.

We have also taken significant steps to upgrade physical security throughout SEC buildings. Specialists have evaluated the structures and installed computerized

identification card authentication systems, cameras, and alarms in key facilities. The number of entrances at our data operations center has been reduced. Guards have been redeployed and retrained. We have also put in place new technology and changes in procedures to restrict access to sensitive rooms on SEC premises, such as data centers and network closets.

We are continuing our efforts to tighten access controls that prevent, limit, or identify inappropriate access to data, equipment, and facilities. All of these controls are designed to prevent unauthorized disclosure, modification, or destruction of sensitive information.

While the SEC has strong access control policies, a number of issues identified during the audit were related to inadequate compliance with existing agency policies by individuals responsible for the system and technical staff. To address this concern, the SEC has stepped up educational and enforcement efforts. System owners—individuals responsible for the system—have been presented with all agency information technology policies and have been directed to sign documentation showing that they have reviewed those policies. Beyond developing an educated population, we are also focused on errors that can happen through inattention. To address such issues, the SEC is implementing a systemic scanning program administered by teams that are organizationally separate from the system owners. System owners will be presented with the results of those scans and directed to correct any vulnerabilities and mitigate risks on systems that do not comply with SEC policies. By implementing a continuous scanning approach, the agency expects to achieve dramatic cost savings. These savings can be achieved because configurations will be corrected early on, before they can have a negative effect on operations. Such practices will also reduce the amount of resources and time required to correct problems in the future.

The SEC also is making efforts to address weaknesses in its IT "change management" processes. These are the processes and procedures that govern the way that software and other technologies are deployed into the SEC's environment. The GAO has recommended a number of improvements to ensure that such deployments do not introduce security weaknesses, whether inadvertently or as the result of an insider with malicious intent. Therefore, we are taking steps to better oversee our environment through such measures as weekly change control board meetings, better communication between the involved groups, improved version management procedures, and an enhanced test environment.

As Chairman, I am committed to implementing all of the GAO's recommendations. I anticipate that we will again see significant improvements in our information security posture at the conclusion of this year's audit.

RISK-BASED EXAMINATIONS—TARGETED ACTIVITIES

Question. In your budget justification document for fiscal year 2008, in the section covering the Office of Compliance Inspections and Examinations and your risk-based examination program, you explain that SEC's resources will be focused on those firms and practices that have the greatest potential for violative conduct that can harm investors.

You state that "higher-risk activities" include those that "create significant conflicts of interest where compliance policies and procedures are insufficient to mitigate those conflicts."

Please explain in greater detail what these "higher risk activities" include, and how you target them.

Answer. Higher risk activities at adviser, funds, and broker-dealers include business practices that create significant conflicts of interest that, if not monitored and mitigated in some fashion, may result in harm to clients or investors, such as: soft dollar arrangements; directed brokerage; performance advertising; custody and possession of client funds and securities; difficult-to-value securities; access to non-public information; and significant personal trading by employees of the firm. In examinations of broker-dealers, our risk-based focus is on areas such as: compliance with capital requirements and operational issues; sales practices including suitability, churning, and unauthorized trading; supervision; new products; order handling and trading rules; and anti-money laundering rules.

The Office of Compliance Inspections and Examinations (OCIE) has implemented a risk-based approach to examinations. OCIE's goal is to identify emerging areas of compliance risk, conduct examinations and take steps to remedy identified problems. Given the number of firms registered with the SEC and the breadth of their operations, the staff continues to focus examination resources on those registrants and activities where the investing public or market integrity is most at risk.

In recent years, the examination program has enhanced its efforts to proactively detect and address potential risks, and provide balanced, cost-effective and reasonable oversight of the regulated community. Many of these higher risk activities have been identified through years of experience with examinations and enforcement activities at registered firms. However, we are continually searching for areas of risk that are new or unique to the investment management community. To assist the staff in identifying risks warranting examination follow-up, OCIE utilizes a risk-identification and risk-assessment methodology. This methodology uses an internal database to identify and prioritize risks, consider mitigating and aggravating conditions, and recommend regulatory or other actions to be taken to remove or mitigate the risks. As part of this risk assessment process, examination staff nationwide provide feedback about where risks may exist in the industry and to propose possible solutions. This risk-assessment process is used to identify risks requiring regulatory or examination follow-up and to build a culture of risk-assessment within the examination program.

Higher risk activities are targeted primarily through our examination process. All of our routine examinations will focus on those activities and areas presenting the greatest concern to investors (many of which are identified above). In addition, exam staff may specifically conduct focused risk targeted examination sweeps to determine the extent and interpret emerging risks in the regulated community. In such examinations, examiners review risk conditions and responsive controls for a particular compliance risk at a sample of firms. This approach allows the staff to obtain a more comprehensive view of the particular risk, assess the gravity of the risk, evaluate the compliance performance of individual firms compared to that of their peers, and suggest regulatory solutions. These examinations may often identify specific areas of interest and risk that are incorporated into our regular examination process.

QUESTIONS SUBMITTED BY SENATOR SAM BROWNBACK

Question. As I mentioned in my statement, recent articles in the "New York Times," "Wall Street Journal," "Financial Times" and "The Economist" have all suggested that tenets of Sarbanes-Oxley are cause for a decrease in American-listed public companies compared to foreign exchanges such as London and Hong Kong, because the Act takes away incentives to list on an American exchange. Do you agree with this assessment?

A recent report by McKinsey & Company commissioned by Senator Schumer and New York City Mayor Bloomberg found that over the first ten months of 2006 U.S. exchanges attracted barely one-third of the share of IPOs they captured back in 2001. During that same time, European exchanges increased market share by 30 percent and Asian exchanges doubled their share. Most importantly, the study found this trend was "due to non-U.S. issuers' concerns about compliance with Sarbanes-Oxley Section 404 and operating in what they see as a complex and unpredictable legal and regulatory environment." Do you agree with these findings? What can we do to stem the flow of companies to foreign exchanges?

Answer. Over the past year, a number of reports have been published which advise the SEC and Congress on how to deal with increasingly global capital markets. They have offered the Commission and policymakers in Congress and the Executive Branch many recommendations. These reports, including the report by McKinsey & Company commissioned by Senator Schumer and Mayor Bloomberg frequently cite the increase in foreign-listed IPOs as cause for concern about the competitiveness of U.S. markets, and cite the Sarbanes-Oxley Act as a contributor to capital flight from the United States.

I agree that Sarbanes-Oxley is a factor in the decision of some issuers to list overseas. I am comfortable stating this because several issuers, underwriters, accountants, and attorneys have shared the reasons behind their decisions to list overseas with me and have cited SOX as a reason. But despite this kind of unfiltered, episodic information much more is at work here. We need to recognize that our capital markets are changing at an accelerating pace and that we are living in a very dynamic, much more competitive world. There are more opportunities to raise money and deeper, more varied pools of capital in other countries than ever before. Even if SOX were provably and quantifiably a determinant in the increase in foreign market IPOs—and sound science does not permit such neat conclusions—the fact is there are simply greater competitive challenges than ever before to the United States' leading position in the world as the largest, deepest, and most liquid markets.

Our continued global market leadership is not America's birthright. We have to constantly earn it. That is true for our private sector and it is true for our regulatory system. As regulators, we must constantly work to sharpen our competitive edge as well. When it comes to SOX, that has meant completely overhauling the expensive, inefficient auditing standard that was used to implement section 404. We recently repealed it and replaced it with a new standard that is clearly written in plain English, is less than half as long, and is risk-based, materiality-focused, and scalable for companies of different sizes. We expect it to dramatically reduce the costs of SOX 404 compliance.

That said, the evidence of some high profile foreign IPOs no longer listing in the United States may simply be an indication that other markets have improved, not that the United States has become unattractive. A steady stream of foreign companies continues to tap the U.S. markets. In fact, according to Thomson Financial, this year is on pace to add the most foreign listings on U.S. exchanges since 1997. It was also recently reported that foreign companies accounted for 23.4 percent of IPO proceeds last year—the highest amount since 1994.

Question. Chairman Cox, the press has reported that the SEC intends to put forward its management guidance in the next few weeks. Can you comment on the timeline to putting forth this guidance and the process for its adoption?

Answer. On May 23, 2007, the Commission unanimously approved interpretive guidance to help public companies strengthen their internal control over financial reporting while reducing unnecessary costs, particularly at smaller companies. The new guidance will enhance compliance under Section 404 of the Sarbanes-Oxley Act of 2002 by focusing company management on the internal controls that best protect against the risk of a material financial misstatement. It is currently in effect.

The Commission also approved rule amendments providing that a company that performs an evaluation of internal control in accordance with the interpretive guidance satisfies the annual evaluation required by Exchange Act Rules 13a–15 and 15d–15. The Commission also amended its rules to define the term "material weakness" as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." The Commission also voted to revise the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting to more clearly convey that the auditor is not evaluating management's evaluation process but is opining directly on internal control over financial reporting. These changes, too, are now in effect.

In addition, the SEC in July 2007 repealed the costly Auditing Standard No. 2, which had made Sarbanes-Oxley compliance so difficult, and replaced it with a completely new standard that is top down, risk-based, materiality focused, and scalable for companies of all sizes. The replacement standard, Auditing Standard No. 5, is now in effect.

Question. The data shows that smaller public companies have experienced a disproportionate burden from Sarbanes-Oxley. Given that you are re-writing the rulebook for management, are you going to do anything to grant further relief for the non-accelerated filers? Some of my colleagues (Sen. Snowe and Sen. Kerry) have called for delayed implementation of the Sarbanes-Oxley Section 404 requirements for small public firms to ease the burden on complying with the expected new auditing standards.

Answer. The question of further deferral for non-accelerated filers is still open. The SEC has, however, already deferred compliance for non-accelerated filers four times in an effort to ensure that the burden of compliance did not unduly impact smaller companies. The very positive result of our determination to phase in 404 for smaller companies is that we and they have had the opportunity to field test the requirements so that smaller companies have the benefit of learning from the experiences of larger firms.

These experiences have deeply informed the SEC's new Interpretive Guidance and the PCAOB's new auditing standard. The continued phased implementation will allow smaller firms to start complying with section 404(a) of SOX starting in 2008, while the first audit under section 404(b) won't be due until 2009.

The SEC's new guidance is intended to be of significant help to small companies. Completing the implementation of Section 404 is important to further enhancing the quality of reporting and increasing investor confidence in the fairness and integrity of the securities markets. The Commission and the PCAOB will continue our ongoing outreach efforts over the coming months to ensure that the changes recently made in the implementation of section 404 live up to our expectations for a more effective and efficient system for all filers. In particular, we will focus on the extent

of the expected cost reductions for first-time accelerated filers during 2008 under the new Auditing Standard No. 5 and our new Interpretive Guidance.

Question. The majority of the problems with Sarbanes-Oxley have been the implementation—not the language itself. What is the SEC going to do to ensure that the fixes put forward in its new guidance are successfully implemented in order to bring the cost-benefit back into alignment?

Answer. With new guidance that allows management to scale and tailor evaluations to focus on what matters most—and with a new auditing standard that enables auditors to deliver more cost-effective audit services—one final step remains. The SEC and the PCAOB expect a change in the behavior of the individuals who are responsible for following these new procedures. To that end, the PCAOB's inspection program will monitor whether audit firms are implementing the new auditing standard in a cost-effective way that is designed to achieve the intended results. And the SEC, in our oversight capacity, will monitor the effectiveness of the PCAOB's inspections. So both the SEC's and the PCAOB's inspectors will be focused on whether audit firms are achieving the desired audit and cost efficiencies in the implementation of 404. The SEC staff will also conduct an economic analysis—using real-world information—to evaluate whether the costs and benefits of implementing section 404 are in line with our expectations.

Question. I understand that, due to concerns about the burdensome effects of section 404 of Sarbanes-Oxley, the Chamber of Commerce has asked that you delay 404 compliance for smaller public companies. Do you plan to delay 404 compliance? How can you limit the burden of section 404 on small companies?

Answer. With respect to the potential for a further delay of 404 compliance for smaller public companies, see the answer to Question 4, above. With respect to other ways that the SEC can reduce the burden of section 404 on small companies, we have very recently approved Interpretive Guidance recognizes that smaller public companies generally have less complex internal control systems than larger public companies.[1] The new Interpretive Guidance is intended to assist management of smaller companies in scaling and tailoring their evaluation methods and procedures, recognizing that what is necessary in a large company may not be appropriate for smaller companies with less complex internal controls systems.

The Interpretive Guidance is intended to allow management sufficient and appropriate flexibility to design an evaluation process that fits its facts and circumstances. We are encouraging smaller public companies to take advantage of the flexibility and scalability afforded in the guidance to conduct an evaluation of internal controls that is both efficient and effective at identifying material weaknesses.

In order to help smaller companies understand how they can tailor their evaluation efforts, the guidance specifically highlights some of the key areas where the evaluation at a smaller company might be different than for a larger company. For example, three key points within the evaluation process are the overall determination of effectiveness of the design of controls, the testing of the operating effectiveness, and the documentation needed to sufficiently support both. The Interpretive Guidance includes guidance on each of those points indicating how a smaller company may accomplish those requirements of the evaluation process.

The guidance explains how a small company might approach 404 differently than a large company. For example:

—A smaller company would probably follow fewer and different steps in evaluating whether its controls will provide reasonable assurance about the reliability of its financial reports.

—Management in a smaller company can go about obtaining information on whether its controls operate as designed in different and less elaborate ways than would be necessary in a large company.

—The documentation needed to provide reasonable support for a smaller company's controls will normally be less than what's required in a larger company.

Question. The Chamber of Commerce has asked that you clarify a number of defined terms so that companies have better guidance about what is required of them to comply with section 404. These terms include "material weakness," "significant deficiency," and "materiality." Have you further clarified the use of these terms?

Answer. On May 23, 2007, the Commission adopted amendments to its rules to define the term "material weakness" as "a deficiency, or combination of deficiencies, in internal control over financial reporting (ICFR), such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." Our intention

[1] *Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission* (Apr. 23, 2006) at 39–40, ("Advisory Committee Report") available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

is to re-focus 404 compliance on the specific problem that Congress had in mind: material risks to reliable financial reporting. In that way, we will better protect investors and companies can more wisely spend their money on meaningful evaluations of internal controls. In addition, the definition of material weakness, including the indicators of material weakness, has been aligned between the Commission's management guidance and the PCAOB's Auditing Standard No. 5 to promote consistency in the considerations made by management and auditors in evaluating deficiencies.

In addition, on June 20, 2007, the Commission issued a release seeking additional comment on a proposed definition of a "significant deficiency." The proposal defines "significant deficiency" as "a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of a registrant's financial reporting." In drafting the proposed definition, we considered comments received by the PCAOB in response to its proposed auditing standard. We believe that the proposed definition reflects the Commission's belief that the focus of the term "significant deficiency" should be the underlying communication requirement that results between management, audit committees and independent auditors. The comment period on this proposal ends on July 18, 2007 and we will evaluate comments received to ensure that the final definition effectively communicates the Commission's objectives.

With regards to materiality, both the SEC and PCAOB received a number of comments, including those received from the Chamber of Commerce, suggesting that more guidance should be issued related to materiality and how it applies to the evaluation and assessment of ICFR. For management, judgments regarding materiality often must consider many factors that can vary based on each company's individual facts and circumstances. These areas are frequently complex and involve significant judgment, which makes providing "bright-line" guidance and examples difficult and presents the risk of unduly restricting management's ability to effectively utilize and apply its informed judgment. Nonetheless, we are continuing to seek feedback on the more challenging issues relative to materiality considerations and the appropriateness of providing additional guidance.

Question. Past chairman of the National Venture Capital Association, Robert Grady, wrote a few weeks ago that section 404 is causing an outcry because it requires "tiny companies to provide shelf after shelf of process-oriented paperwork, at the cost of millions of dollars, that no investor is even likely to read." Do you agree with this assessment? How can we—as Grady says—"bring sanity to this process?"

Answer. The SEC is keenly attuned to making sure that the U.S. capital markets remain robust and competitive, and to helping small businesses remain competitive in the global marketplace. To date, no tiny company—this is, no company with public float of less than $75 million—has had to comply with section 404.

To "bring sanity to this process," as Mr. Grady suggests, the SEC is working to make sure that its regulations are scalable and that they do not impose an undue burden on small businesses. In May 2007, the SEC proposed and adopted a number of changes—in the way private offerings are conducted in the United States, and in the section 404 internal controls reports that companies are required to file with us—that address both scalability and competitiveness.

We continually review our regulations with a view towards reducing the burdens of being a public company and to remove obstacles to raising capital, consistent with investor protection. On May 23 the Commission approved an entire package of rule change proposals designed to modernize and streamline capital raising and reporting requirements affecting small business. The small business improvements that the SEC recently proposed include:

—Giving small businesses access to the expedited "shelf" registration process for their own securities offerings, which previously was available only to big companies.

—Cutting paperwork for thousands of small businesses, by allowing them to raise capital in a private offering after filing a simplified Form D online.

—Establishing shortened holding periods for restricted securities, making it easier for small business shareholders to put their securities on the market sooner and hopefully reducing the discount that small businesses must absorb to sell restricted securities.

—Giving issuers the benefit of a new, limited offering exemption from Securities Act registration requirements for offerings and sales of securities to a newly defined category of "qualified purchasers" in which limited advertising would be permitted.

—Eliminating the limit on the number of employees who can receive stock options from their fast-growing private firms, improving the ability of emerging growth

companies to attract and retain talent without prematurely triggering the requirements of the Exchange Act.

—Providing a simplified system of disclosure for almost 1,600 additional smaller public companies, an increase of over 45 percent in the number of small companies that are currently eligible.

Many of these rule proposals address key recommendations made by the Commission's Advisory Committee on Smaller Public Companies. We look forward to further input from the small business community as we receive the public comments on those proposals. We will continue to consider additional recommendations made by the Advisory Committee.

Question. A new undertaking of the SEC is the oversight of credit rating agencies. Could you please tell me a little bit more about this and what led the SEC to begin this new project?

Answer. On May 23, 2007, the Commission voted to adopt final rules to implement provisions of the Credit Rating Agency Reform Act of 2006, which was enacted into law in September 2006. The Credit Rating Agency Reform Act defines the term "nationally recognized statistical rating organization" (NRSRO), provides authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies. The Commission acted well in advance of the statutory deadline to establish the regulatory regime for rating agencies and to lower the barriers to entry into this market.

The goal of this new law is to improve credit ratings quality by fostering competition, accountability, and transparency in the credit rating industry. The heart of the Act calls on the Commission to replace the barriers to entry that had previously existed. The replacement is a transparent and voluntary Commission registration system that favors no particular business model. The SEC adopted rules in each of these areas that would implement the Credit Rating Agency Reform Act.

Question. What are the methods of enforcement used against violators of federal securities laws?

Answer. Investigations begin when the staff obtains information from any of a wide range of sources about a possible violation of the securities laws. Sources include the surveillance units at the exchanges, examinations of regulated entities, issuer filings, news reports, and investor complaints. When the staff first obtains a lead, it conducts a preliminary inquiry. If the lead seems promising, the staff opens an informal investigation and requests voluntary submission of documents and sworn testimony from witnesses. If the staff cannot obtain documents or testimony voluntarily, the Commission can issue a formal order of investigation, which authorizes the staff to issue subpoenas for testimony and the production of documents. If an investigation uncovers evidence of wrongdoing, the staff meets with the Commission, presents a description of the case, suggests what action is appropriate and discusses various alternatives. The Commission may then authorize the staff to begin public enforcement action in a federal district court or before a Commission administrative law judge. The Commission may also accept proposals submitted by the alleged violated to settle the proposed charges.

The securities laws provide for a broad range of sanctions, including: cease-and-desist orders, censures, injunctive relief, disgorgement, civil penalties, and industry bars. Moreover, civil monetary penalties may be imposed in cases involving repeat violations and severe frauds. The Commission's full range of existing remedies ensure that the Commission can effectively prosecute cases. This is particularly true given the SEC's ability to make criminal referrals in the most egregious cases.

Question. Commissioner Cox, would you please explain how the SEC cooperates with foreign authorities especially regarding cross-border enforcement?

Answer. Because fraudsters take advantage of borderless capital markets, the SEC requests assistance from foreign counterparts in all types of investigation—from fraud committed by investment advisers, to market manipulation schemes, to account intrusion cases, to international insider trading rings. To promote information sharing in cross-border securities investigations, the SEC was a founding member of the International Organization of Securities Commissions (IOSCO), and supported IOSCO's endorsement of the Multilateral Memorandum of Understanding (MMOU) in 2002. The MMOU requires signatories to meet international standards for international enforcement cooperation. The growing number of signatories to the MMOU is strong evidence of the increasing ability of our foreign colleagues to assist in international investigations. In fact, a number of foreign counterparts have strengthened their laws in order to be able to meet the international standard required to join the MMOU and thus be considered among the responsible members of the international enforcement community. As of September 2006, 34 securities and derivatives regulators had become signatories to the MMOU, and 9 additional IOSCO members had expressed their commitment to become signatories.

We are also witnessing an increase in the number of investigations (and, consequently, the number of requests for assistance) in major capital markets, such as Canada and Australia, with enforcement programs similar to our own. We are also seeing fervent enforcement efforts in other less developed markets. Some of the nations whose markets are emerging, whose enforcement laws are newly minted or strengthened, or whose regulatory agencies are recently established are keen to establish robust enforcement programs. The tremendous demand for the SEC to send staff to train foreign investigators demonstrates our counterparts' interest in effective enforcement and in combating securities fraud. In response, the SEC conducts technical assistance and training which, over the course of close to 20 years, has resulted in more effective enforcement programs around the world.

The most prominent type of illegal activity as to which our foreign counterparts seek assistance is in the area of insider trading. In the past 13 months, the SEC has received over 50 requests from our foreign counterparts to assist in insider trading investigations. During this same time frame, we have also received a substantial number of requests from abroad seeking assistance in market manipulation investigations (that is, cases where fraudsters may have manipulated the market price of a company's stock by false representations about the company or by illegal trading in the stock.)

CONCLUSION OF HEARINGS

Senator DURBIN. This meeting of the subcommittee will stand recessed.

[Whereupon, at 3:58 p.m., Wednesday, May 16, the hearings were concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

Material Submitted Subsequent to the Hearings

FEDERAL DEPOSIT INSURANCE CORPORATION

PREPARED STATEMENT OF JON T. RYMER, INSPECTOR GENERAL, OFFICE OF THE INSPECTOR GENERAL

Mr. Chairman and Members of the Subcommittee: I am pleased to present the fiscal year 2008 budget request totaling $26.8 million for the Office of Inspector General (OIG) at the Federal Deposit Insurance Corporation (FDIC), the first budget request since I took office on July 5, 2006. This request will allow us to continue meeting our statutory responsibilities and assist the FDIC in effectively carrying out its mission.

As you know, the Congress created the FDIC in 1933 as an independent executive agency, during the Great Depression, to maintain stability and public confidence in the nation's banking system. Our nation has weathered several economic downturns since that era without the severe panic and loss of life savings unfortunately experienced in those times. The federal deposit insurance offered by the FDIC is designed to protect depositors from losses due to failures of insured commercial banks and thrifts. The Congress enacted deposit insurance reform legislation that will maintain insurance coverage for individual accounts at $100,000, but provides for inflation indexing every 5 years beginning in 2011. Also, as of April 1, 2006, coverage for certain retirement accounts increased to $250,000 from $100,000, with similar inflation indexing. According to most recent FDIC data, as of December 31, 2006, the FDIC insured $6.6 trillion in deposits for 8,693 institutions, of which the FDIC supervised 5,220. The FDIC promotes the safety and soundness of these institutions by identifying, monitoring, and addressing risks to which they are exposed.

The Corporation reports that industry earnings are at record-high levels, bank capital is historically high, and loan performance has slipped only slightly from record levels. Currently, there are 50 institutions on the "problem list"—one of the lowest numbers in the history of the FDIC. Unfortunately, the 31-month streak of no failures—the longest in FDIC history—ended in February 2007, when one small institution, Metropolitan Savings Bank, failed. Still, the financial health of the banking industry remains very good overall. As for the economy, it is now in a sixth year of expansion; however, U.S. economic growth appears to be slowing significantly and some negative trends are emerging in the banking sector. They include a narrowing of net interest margins; increasing concentrations of riskier commercial real estate loans; and signs of credit distress in subprime mortgage portfolios. As economic conditions shift, the OIG is poised to focus its work on the challenges facing the FDIC in monitoring and assessing various existing and emerging risks to insured depository institutions and the Deposit Insurance Fund.

The FDIC OIG is an independent and objective unit established under the Inspector General Act of 1978, as amended. The OIG's mission is to promote the economy, efficiency, and effectiveness of FDIC programs and operations, and protect against fraud, waste, and abuse to assist and augment the FDIC's contribution to stability and public confidence in the nation's financial system.

Before discussing our budget needs for fiscal year 2008, I would like to highlight some of our accomplishments from the past fiscal year, our assistance to FDIC management, our planning and internal initiatives to improve the OIG, and the management and performance challenges facing the FDIC.

A REVIEW OF THE FDIC OIG'S FISCAL YEAR 2006 ACCOMPLISHMENTS

As in past years, during fiscal year 2006, our work in audits, evaluations, and investigations resulted in a number of major achievements, as follows: $44.9 million in actual and potential monetary benefits; 26 audit and evaluation reports issued; 82 non-monetary recommendations to FDIC management; 49 referrals to the Department of Justice; 42 indictments/informations; 26 convictions; 1 employee/disciplinary action.

More specifically, our accomplishments included investigations that led to the above indictments and convictions as well as fines, court-ordered restitution, and recoveries that constitute slightly over $39 million in actual and potential monetary benefits from our work. Our audit and evaluation reports included about $3.4 million in questioned costs and $1.5 million in recommendations that funds be put to better use. The audit and evaluation reports contained non-monetary recommendations to improve FDIC policies, operations, and controls that ultimately are designed to improve the FDIC's ability to effectively and efficiently accomplish its mission.

On the whole, the OIG accomplished all of its organizational goals during the fiscal year, as outlined in our annual performance plan. Our 2006 Performance Report shows that we met or substantially met 100 percent of our goals. In a measurable way, this achievement shows the progress we continue to make in adding value to the Corporation with our audits, investigations, and evaluations in terms of impact, quality, productivity, and timeliness.

The following audit, evaluation, and investigative work illustrates some of the OIG's accomplishments in fiscal year 2006:

—Audit reports addressed significant issues. For example, one report contained recommendations to ensure that the FDIC periodically validates key assumptions, estimates, or other components that factor into the calculation of the reserve ratio, which is the ratio of the balance in the Deposit Insurance Fund to estimated deposits in the banking system. In connection with corporate governance practices, this report also recommended improved communication of information relevant to deposit insurance assessment determinations and other corporate matters and activities to the FDIC Board of Directors. Several reports dealt with various consumer protection and community reinvestment issues, including predatory lending, use of Home Mortgage Disclosure Act data to identify and assess instances of potential discrimination in FDIC-supervised institutions, and the FDIC's process for addressing the violations and deficiencies reported in compliance examinations. Our Federal Information Security Management Act-related audits have contributed to the FDIC making significant progress in the past several years in improving security controls and addressing current and emerging information security requirements.

—Evaluation reports focused on a number of important corporate issues, including the industrial loan company application process, the FDIC's safeguards over personal information, contract administration, and the FDIC's emergency response plan. The reports have generally contributed to strengthened program controls and improved corporate governance of FDIC operations.

Successful investigative outcomes included the following:

—The former president and chief executive officer of Hawkeye State Bank (HSB) was ordered to pay $3.7 million in restitution based on his stipulating to having caused $4.9 million in losses to HSB. He was sentenced to 65 months of incarceration and 5 years of supervised release.

—The former president of the First National Bank of Blanchardville was sentenced to 9 years' incarceration and ordered to pay restitution of $13 million to the FDIC.

—The former chairman of the board and chief executive officer of Hamilton Bank was sentenced to 30 years of incarceration and 36 months of supervised released. He had earlier been convicted on all 16 charges of making false filings to the Securities and Exchange Commission and to bank examiners, making false statements, wire fraud, bank fraud, securities fraud, obstruction of a bank examination, and conspiracy. He, along with two other convicted Hamilton Bank officers, was ordered to pay $32 million in total restitution for bank and securities fraud, $16 million of which is payable to the FDIC.

—The former chief executive officer (CEO) of the now defunct Sunbelt Savings and Loan of Dallas, Texas, an institution whose insolvency cost taxpayers approximately $1.2 billion, was sentenced to 15 years' imprisonment and ordered to pay a criminal forfeiture of $2 million to the United States Government and restitution in the amount of $312,828 to the FDIC. The former CEO was convicted on 27 counts involving defrauding the FDIC of its payments of $7.5 million and $8.5 million in a civil judgment resulting from his 1990 guilty plea to federal fraud charges in connection with the collapse of Sunbelt.

ASSISTANCE TO FDIC MANAGEMENT

In addition to audits, investigations, and evaluations, the OIG made valuable contributions to the FDIC in several other ways. Among these contributions were the following activities:

—Reviewed 14 proposed corporate policies and offered comments and suggestions when appropriate (e.g., Employee Rights and Responsibilities under the Privacy Act of 1974, Encryption and Digital Signatures for Electronic Mail, Protection of Privacy Information, the FDIC's Software Configuration Management Program, and Enterprise Risk Management);
—Participated in division-level conferences and meetings to communicate our audit, evaluation, and investigation work and processes;
—Provided technical assistance and advice to several FDIC groups working on information technology issues, including participating at the FDIC's information technology security meetings;
—Reviewed and/or commented on four draft legislative documents and regulations.

We are committed to continuing to demonstrate to the Congress, the public, the FDIC, and the banking industry that the OIG is doing the right things and generating results that are a worthy return on the investment made in us.

OIG PLANNING AND INTERNAL INITIATIVES

In fiscal year 2006, we undertook a comprehensive and integrated approach to planning OIG audits, evaluations, investigations, and internal activities, resulting in a Business Plan that captures our strategic goals, performance goals, and key efforts. We have been planning, conducting our work, and reporting our results in the context of these strategic goals since that time and will continue to do so in fiscal years 2007 and 2008. The OIG's work is centered on five strategic goals that link directly to the FDIC's mission, principal business lines, and significant challenges: Supervision, Insurance, Consumer Protection, Receivership Management, and Internal Resources Management. To these, we added a goal related to our internal processes in the interest of continuing to build and sustain a high-quality OIG work environment. We are pursuing that goal intently through a number of operational improvement projects.

These projects include professional development; human capital management and leadership development; client, stakeholder, and staff relationships; quality and efficiency of OIG work; strategic and annual performance planning and measurement; and information technology. These initiatives are important for the OIG to ensure that we build and sustain the quality of our work and remain a results oriented high-performance organization, use our resources wisely, and stay abreast of the significant and ever-changing challenges facing the FDIC and the financial services industry.

The complete 2007 Business Plan can be found on our Web page at http://fdicig.gov or obtained by contacting our office. Consistent with our working Business Plan, we are currently developing performance goals and key efforts for fiscal years 2008 and 2009, which will continue building on our six strategic goals. We will also continue to coordinate closely with the Congress, FDIC management, financial regulatory OIGs, others in the IG community, the U.S. Government Accountability Office, and law enforcement agencies as we plan and conduct our upcoming work.

MANAGEMENT AND PERFORMANCE CHALLENGES FACING THE CORPORATION

As part of our planning and budgeting process, the OIG annually assesses the most significant management and performance challenges facing the Corporation, in the spirit of the Reports Consolidation Act of 2000. In identifying those challenges, we consider the FDIC's strategic goals and the Chairman's corporate priorities and objectives. Identifying these challenges helps guide our work. In February 2007, we identified the following management and performance challenges facing the Corporation for inclusion in the Corporation's Performance and Accountability Report: addressing risks in large banks; maintaining strong regulatory capital standards; implementing deposit insurance reform; maintaining an effective examination and supervision program; granting insurance to and supervising industrial loan companies; guarding against financial crimes in insured institutions; safeguarding the privacy of consumer information; promoting fairness and inclusion in the delivery of information, products, and services to consumers and communities; ensuring compliance with consumer protection laws and regulations and follow-up on violations; being ready for potential institution failures; and promoting sound governance and managing and protecting human, financial, information technology, physical, and procurement resources.

FDIC Chairman Bair recently expressed her views on several challenges that the Corporation is facing and that she believes will continue to warrant attention over the next few years. The Chairman highlighted the following challenges as "front-burner" issues:

—Making sure the FDIC has a strong, vigilant supervisory program and creating a strong interrelationship between compliance and risk management;
—Implementing deposit insurance reform to help ensure a deposit insurance pricing system that reinforces the supervisory program;
—Maintaining strong regulatory capital standards under Basel II;
—Granting insurance to and supervising industrial loan companies;
—Promoting fairness and inclusion in the delivery of information, products, and services to consumers and communities; and
—Promoting sound governance and managing resources.

In addition to these priorities, Chairman Bair recently testified before the House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services regarding other management and performance challenges facing the Corporation. Chairman Bair focused on the following:

—Strengthening protections available to borrowers in the subprime mortgage market; and
—Ensuring that predatory lending practices do not take root in the banking system.

Clearly, our assessment of corporate challenges and the Chairman's articulation of priority issues are closely aligned. We look forward to continuing to work with the Congress and corporate officials to address all of these challenges successfully.

OIG'S FISCAL YEAR 2008 REQUEST

Our fiscal year 2008 budget request seeks the resources necessary to allow the OIG to continue its efforts in audit, investigative, and evaluation work. In addition, our funding allows us to continue to enhance knowledge capacity, employee programs, and operational improvement projects. These funds are essential to helping us remain prepared to meet the complex issues and challenges confronting the FDIC. The funds are critical to ensure that OIG can continue to provide our clients with timely, objective, and reliable information on how well FDIC programs, operations, and policies are working, and, when needed, recommendations for improvement. The OIG is an invaluable tool for helping the FDIC protect against fraud, waste, and abuse to assist and augment the Corporation's contribution to stability and public confidence in the nation's financial system.

At this time, we anticipate handling a 2008 investigative workload comparable to that of 2007. With respect to 2008 audit and evaluation work, we also anticipate a similar level of effort, with sustained attention to many of the Chairman's corporate priorities. Some key efforts begun in fiscal year 2007 will carry over into fiscal year 2008. To remain responsive to ever-changing priorities and emerging issues, we will keep close track of our planned work and make adjustments, as needed, to maximize the value that we add.

After 11 years of consecutive budgetary decreases, our fiscal year 2008 budget request in the amount of $26,848,000 represents a modest increase of $592,000 (or 2.2 percent) over our fiscal year 2007 funding level. This budget request reflects a stabilized OIG operating environment and will support a full-time equivalent staff of 127, down 3 from fiscal year 2007. Even with the reduction in staffing, the slight increase in budget is required to help absorb higher projected expenses for employee salaries and benefits costs and non-personnel related expenses. As in past years, funds for the OIG budget would be derived from the Deposit Insurance Fund and the Federal Savings and Loan Insurance Corporation Resolution Fund.

CONCLUDING REMARKS

I appreciate the support and resources we have received from this Subcommittee, the Congress, and the FDIC. As a result, the OIG has continued to pursue successful investigations and to make a difference in FDIC operations in terms of financial benefits and improvements and strengthened internal operations and efficiency. I look forward to continue working with this Subcommittee in years to come. I believe our fiscal year 2008 budget strikes an appropriate balance between the mandate of the Inspector General Act, other legislative requirements, our judgments of OIG workload needs, and the changing conditions in the banking industry. We continue to seek your support so that we will be able to effectively and efficiently conduct our work on behalf of the Congress, the FDIC, and the American public.

NONDEPARTMENTAL WITNESS

PREPARED STATEMENT OF INDEPENDENT SECTOR

Mr. Chairman and Members of the Committee: Independent Sector appreciates the opportunity to comment on fiscal year 2008 federal appropriations for Internal Revenue Service activities.

Independent Sector is a nonprofit, nonpartisan coalition of approximately 575 charities, foundations, and corporate philanthropy programs, collectively representing tens of thousands of charitable groups in every state across the nation. Our mission is to advance the common good by leading, strengthening, and mobilizing the charitable community. We have worked since our inception to help our member organizations meet the highest standards of ethical practice, accountability, and effectiveness.

We support increased funding of the Internal Revenue Service's fiscal year 2008 budget and write today to urge you to appropriate the level recommended by the IRS Oversight Board: $11.406 billion, $310.1 million above the President's budget request.[1] The increased funding is necessary to develop more effective oversight and enforcement of the laws regulating charities and foundations as well as comprehensive education of nonprofit organizations about their obligations under those laws.

An Ethical, Accountable Nonprofit Community is Essential to Nonprofits' Ability to Improve Lives

Our country's growing nonprofit community works to improve lives in communities across America and around the world. It provides vital services in such fields as health, education, social assistance, community development, and the arts.

Crucial to fulfilling our missions is our ability to demonstrate to our stakeholders—donors, beneficiaries, volunteers, and policymakers—that we operate ethically and accountably. Only if we earn and maintain their trust will we receive their continued support. Preservation of that trust depends upon a combination of vigorous self-regulation by charitable organizations and effective enforcement of the law.

In recent years, media stories have revealed a number of instances of abuse by taxpayers using charitable organizations for personal gain and individuals claiming excessive contributions. Former IRS Commissioner Mark Everson encapsulated this threat in testimony before Senate appropriators in April 2005, "[i]f we do not act expeditiously, there is a risk that Americans will lose faith in our nation's charitable organizations. If that happens, Americans will stop giving and those in need will suffer."[2]

Concerned about the cumulative impact of abuse and convinced of the need for better enforcement, in 2004, at the encouragement of the Chairman and Ranking Member of the Senate Finance Committee, Independent Sector brought together leaders from all corners of the nonprofit community to create the Panel on the Nonprofit Sector. The Panel was charged with considering and recommending actions to ensure that charities and foundations maintain the highest possible ethical standards. It submitted its Final Report to Congress and the Nonprofit Sector[3] in June 2005 proposing more than 120 actions to be taken by charitable organizations, Congress, and the IRS.

A key recommendation of the Panel is to increase resources allocated to the IRS for oversight of charitable organizations as well as overall tax enforcement. As noted by the Panel, effective oversight of the nonprofit community requires vigorous enforcement of the law. It continued, "without adequate resources for oversight and enforcement, those who willfully violate the law will continue to do so with impunity."[4]

Comptroller General David Walker echoed the Panel's recommendation in congressional testimony in 2005: "Oversight can help sustain public faith in the sector and ensure that exempt entities stay true to the purposes that justify their tax ex-

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[1] IRS Oversight Board, "Fiscal Year 2008 IRS Budget Recommendation, Special Report," at 13 (April 2007).

[2] Hearing on Internal Revenue Service Fiscal Year 2006 Budget Request Before the Senate Comm. on Appropriations, Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies, 109th Cong. 8 (2005) (statement of Mark W. Everson, Commissioner, Internal Revenue Service).

[3] Panel on the Nonprofit Sector, "Strengthening Transparency, Governance, and Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector," available at http://www.nonprofitpanel.org/final/Panel__Final__Report.pdf (June 2005).

[4] Id. at 25.

emption. It also can help protect the entire sector from potential abuses initiated by a small minority."[5]

Additional Resources are Needed to Restore and Grow IRS Enforcement Capacity

Following a dramatic decline in IRS enforcement resources during the 1990s, Congress has in recent years enacted targeted increases to the IRS budget. We applaud and appreciate these investments, which have enabled the IRS to initiate critical investigations into potential areas of noncompliance, including political intervention by nonprofits, executive compensation practices, and abuses by credit counseling agencies.

However, the IRS's enforcement capacity has not yet fully rebounded. As the Government Accountability Office noted in a recent statement before this subcommittee, "[a]lthough IRS has increased direct revenue collected through its enforcement programs in recent years, enforcement continues to be included on our list of high-risk federal programs."[6]

IRS enforcement resources have not kept pace with the dynamic growth of the nonprofit community. Over the past 20 years, the number of charities and foundations has nearly doubled in size, with applications for tax-exempt status increasingly steadily. During that time period, the number of staff within the IRS Tax Exempt and Government Entities Division has remained essentially unchanged.[7] In fiscal year 2006, the most recent year for which data is available, the IRS examined 34 percent fewer tax-exempt returns than it did in fiscal year 1997.[8]

The recent enactment of the Pension Protection Act of 2006 (Public Law No. 109–280) has put yet additional pressure on the IRS, making the need to strengthen the IRS more urgent. The Pension Protection Act (PPA) included what one IRS official has categorized as the most "significant, comprehensive legislation" affecting tax-exempt organizations since 1969.[9] It contained various provisions, many of which reflected the recommendations of the Panel on the Nonprofit Sector, designed to deter individuals who would use charitable organizations for personal benefit and to ensure that donations are used for charitable purposes.

Since enactment of PPA, the IRS has issued several pieces of guidance implementing and explaining the new law. However, much more has yet to be done. For example, PPA mandated that the IRS complete a study on supporting organizations and donor-advised funds by August 2007. The IRS has additionally pledged to develop guidance on a number of issues in the coming year as well as to continue efforts to overhaul the Form 990, the annual Return of Organization Exempt From Income Tax, to reflect new filing requirements enacted as part of PPA as well as other much-needed modifications.

Recognizing the importance of building staff capacity and stronger enforcement mechanisms, the Administration requested in its fiscal year 2008 budget funding to support 12 IRS enforcement initiatives, including a program to increase tax-exempt entity compliance. Echoing the IRS Oversight Board, we applaud the President's commitment to restoring and strengthening the oversight capacity of the IRS. However, we urge you to fund the initiatives at the level recommended by the Board—$351.4 million, or $105 million above the President's request.[10] Increased funding will better equip the IRS to serve its enforcement functions—to ensure nonprofits meet the requirements of the tax laws, in particular the new mandates included in PPA, and help to protect charitable organizations from unscrupulous individuals looking to exploit them for personal gain.

Education and Outreach are Needed to Enhance Voluntary Compliance

As articulated in its guiding principle—"service plus enforcement equals compliance"—the IRS will only achieve maximum compliance with our nation's tax laws

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[5] Tax-Exempt Sector—Governance, Transparency, and Oversight are Critical For Maintaining Public Trust: Hearing on an Overview of the Tax-Exempt Sector Before the House Comm. on Ways and Means, 109th Cong. 1 (2005) (statement of David M. Walker, Comptroller General of the United States, Government Accountability Office).

[6] Internal Revenue Service, Assessment of the 2008 Budget Request and an Update of 2007 Performance: Hearing on the Department of Treasury's Budget Request and Justification for Fiscal Year 2008 Before the Senate Comm. on Appropriations Subcommittee on Financial Services and General Government, 110th Cong. 1 (2007) (statement of James R. White, Director, Strategic Issues, Government Accountability Office and David A. Powner, Director, Information Technology Management Issues, Government Accountability Office).

[7] Statement of David M. Walker, supra note 5, at 17.

[8] Internal Revenue Service, "Fiscal Year 2006 Enforcement and Service Results," at 7 (November 20, 2006).

[9] Christopher Quay, *IRS Focusing on Forms, Education Issues Related to Pension Act, Official Says*, Tax Analysts, March 14, 2007, at Doc 2007–6377.

[10] IRS Oversight Board, supra note 1, at 17–19.

if it balances its oversight activities with a strong program of education, outreach, and accessibility.

Recent increases in the IRS budget have enabled the agency to develop myriad new educational tools for charitable organizations, including issue-specific teleconferences and web forums; an online training workshop, www.stayexempt.org; and numerous fact sheets and notifications. As in the enforcement arena, however, the passage of PPA makes additional IRS education crucial.

PPA increased the complexity of laws governing charitable organizations. Nonprofits will look to the IRS for explanation and guidance as they attempt to comply with these important new mandates. Tax practitioners too will turn to the IRS for technical guidance to ensure that they accurately and effectively advise their nonprofit clients.

The large number of small organizations within the nonprofit community magnifies the need for stronger education. The majority of nonprofit organizations are community-based groups, many of which rely entirely on voluntary staff. Of the one million 501(c)(3) organizations registered with the IRS in 2004, approximately 63 percent had annual revenues of less than $25,000 and were not required to file with the IRS. Of those obligated to file with the agency, nearly 63 percent reported total budgets of less than $200,000.[11]

PPA mandates a new reporting requirement for the smallest organizations, those with annual receipts of less than $25,000. Failure to comply for three consecutive years will result in revocation of tax-exempt status. Oversight alone will not ensure these organizations—some 600,000 groups, the majority of which do not have access to tax and accounting advisers—comply with the law. It will be incumbent upon the IRS to find and notify these organizations of their new responsibility. The IRS Oversight Board's budget recommendation would enable the IRS to meet these service needs—to reach out to and educate nonprofit organizations that want to comply with the law but may not know how—while balancing its enforcement responsibilities.

CONCLUSION

Following a significant decline in resources, the Internal Revenue Service has made great strides toward restoring its tax enforcement program while maintaining adequate taxpayer services. This achievement is due in large measure to recent investments by Congress. We applaud and appreciate these efforts.

However, we concur with the recommendations of former IRS Commissioner Everson, the GAO, and others that additional resources are necessary to enable the IRS to continue to ensure effective oversight of the charitable sector and enforcement of our tax laws, while also maintaining taxpayer service. In order to help preserve and grow public trust in the nonprofit community's ability to improve lives and strengthen communities, we urge you to fund the IRS in fiscal year 2008 at the level recommended by the IRS Oversight Board: $11.406 billion.

We thank you for your consideration of these comments. If you have any questions, please feel free to contact Patricia Read, Independent Sector's Senior Vice President of Public Policy and Government Affairs, by phone at (202) 467–6100 or by email at patr@independentsector.org.

[11] Independent Sector analysis of the National Center for Charitable Statistics Core Data Files for Public Charities and Private Foundations. Analysis run on May 16, 2007. Internal Revenue Service, "Internal Revenue Service Data Book, 2006," at 56.

LIST OF WITNESSES, COMMUNICATIONS, AND PREPARED STATEMENTS

SUBJECT INDEX

COMMODITY FUTURES TRADING COMMISSION

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

FEDERAL DEPOSIT INSURANCE CORPORATION

OFFICE OF MANAGEMENT AND BUDGET

SECURITIES AND EXCHANGE COMMISSION

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